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REVENUE AND SPENDING PROPOSALS FOR FISCAL YEAR 1990

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

MARCH 14 and 15, 1989

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REVENUE AND SPENDING PROPOSALS FOR FISCAL YEAR 1990

TUESDAY, MARCH 14, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
WASHINGTON, DC.

The hearing was convened, pursuant to notice, at 10:15 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman) presiding.

Also present: Senators Baucus, Bradley, Daschle, Packwood, Danforth, Chafee, Heinz, Durenberger and Symms.

[The prepared statements of Senators Chafee and Durenberger appear in the appendix.]

[The press release announcing the hearing follows:]

[Press Release No. H-10, March 1, 1989]

BENTSEN ANNOUNCES FINANCE COMMITTEE HEARINGS ON REVENUE AND SPENDING PROPOSALS IN THE 1990 BUDGET

WASHINGTON, D.C.—Senator Lloyd Bentsen (D., Texas), Chairman, announced Wednesday that the Committee on Finance will hold a series of hearings in March on revenue and spending proposals contained in President Bush's budget for fiscal year 1990.

The hearings are scheduled for *Thursday, March 9; Tuesday, March 14; Wednesday, March 15, 1989, at 10:00 a.m.* in room SD-215 of the Dirksen Senate Office Building.

Bentsen said the March 9 hearing will examine the underlying economic assumptions contained in President Bush's budget; the hearing on March 14 will consider the President's proposal to lower the tax rate on capital gains from the current 33 percent to 15 percent; in the March 15 hearing, the Committee will hear from the Treasury Department about their other revenue proposals as well as expiring tax provisions not included in the Bush budget; and on March 16, the hearing will analyze proposed spending cuts contained in the 1990 budget.

"I want to give the President's budget a fair hearing. Some attractive ideas have been outlined, but at the same time, legitimate concerns have been raised about some aspects of the budget. The Committee will closely examine the President's proposals for outlay and revenue changes, as well as the economic assumptions which underlie the Administration's deficit projections," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS

The CHAIRMAN. This hearing will come to order.

One of the reasons that our budget deficit has persisted for so long is we look at the budget on a year-to-year basis, rather than looking down the road as well. In our deliberations this year, I want the Finance Committee to take the long view. I will not look kindly on something that may well spur the amount of revenue that is collected in one year, but lays the ground work for the deficit to surge by increasing amounts in subsequent years.

The President has made a intriguing proposal to lower the capital gains rate. I do not think many would question that it would provide a 1-year boost in revenue. But the rub comes when you consider what the proposal would do to the deficit in subsequent years. The Joint Tax Committee estimates that over the next 5 years the President's proposal would lose revenue, swelling the Federal deficit by $13.3 billion. Now, that is the Joint Tax Committee's estimate.

But under the Treasury's estimate—which counts for Gramm-Rudman purposes—it would actually gain revenue and reduce the Federal deficit by $16 billion, which would be enough to take care of other tax cuts that the President has proposed.

Now it is really vital that we find out who is right on this one. In doing that, it is going to be instructive, to remember what happened 2 years ago. At that time, under the 1986 bill we had Treasury coming in and saying that if we dropped the top rate from 50 percent to 28 percent, one of the ways we could help pay for it was by raising the capital gains rate back up from 20 percent to 28 percent; if we would do that, that would bring us $21.8 billion over the 5 years.

Now today we have the Treasury coming in and saying that if we cut that rate we will pick up $16 billion. The capital gains rate went up in 1986 as part of a package that dramatically lowered tax rates on ordinary income. The lower top rate acts as a spur to investment. But now we are being asked to reconsider a single part of that package—the capital gains rate.

Our overriding priority has to be to lower the budget deficit; that is not a 1-year project. Yet, now we are being asked to make a permanent change in the tax law. There is a very real danger that the President's proposal could work against our long-term interest.

I will listen with a great deal of interest to representatives of the Joint Tax Committee and the U.S. Treasury explain that $29 billion disparity and their estimate of the revenue effect of a capital gains tax break over the next 5 years.

[The text of "Tax Treatment of Capital Gains and Losses" (JCS-7-89), and "Description of Expiring Tax Provisions" (JCS-8-89), from the Joint Committee on Taxation can be found in the appendix.]

The CHAIRMAN. I now defer to my distinguished friend from Oregon, the ranking minority member.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Both the chairman and I are aware of the grief we took in 1986 when we eliminated the special capital gains rate. But one of the things that we could at least take solace in is that we got rid of it for everybody. There were no distinctions between oil and timber, or oil and timber and real property, or oil and timber and real property and stocks. At least we could say, if this is good for the country—or if it is bad for the country—it affects equally everyone who is affected by capital gains equally.

Now I find Treasury has come back with a proposal that does not include timber. I will be very parochial, Mr. Chairman. I cannot accept this proposal period, on that basis. I will not accept it and I will do everything I can, absent any other factors, to stop it if the proposal discriminates in that way.

There are many other factors to be considered. The Chairman is asking—does it raise money? Does it lose money? It is a fair question. I am not sure we will know anymore at the end of this hearing, or at the end of five hearings than we know now as to whether it gains money or loses money. I have read all the testimony and past testimony. It is roughly the same people, saying roughly the same thing, Mr. Chairman.

I look forward to the hearing. There is one question I wish some of the witnesses would address. The argument is—probably correctly, although seeing Dr. Roberts' testimony has a slightly different view of it—that capital gains does disproportionately favor the wealthy. Assuming that is true—and again, assuming that the proposal raises money, because if it loses money, obviously, it is going no place—but assuming it does raise money and it raises it disproportionately from the wealthy, what is wrong with that? Because the only way this proposal would raise more money from them is if they make more money. I fail to see where the country comes out a loser on that. Whether you are making under $10,000 or over $100,000, if there is more money made, and more investment made, and more capital gains realized, and the Government gains more revenue, then who is the loser?

I would appreciate it if the witnesses would consider that in their testimony.

Thank you, Mr Chairman.

The CHAIRMAN. Thank you.

Senator Bradley.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. Mr. Chairman, thank you very much.

One of the most significant aspects of the 1986 act was the elimination of the differential for capital gains. In terms of reform, it was the first time in generations that the tax rate on capital was the same as the tax rate on labor. From the standpoint of equity, it was probably the most significant reform in the 1986 act.

We are now considering a proposal to go back on the compromise that produced a 28 percent rate. I can see out there in the wings a whole series of unholy coalitions. I think that by the time we would seriously consider the proposal in a markup, what would emerge would certainly produce a revenue shortfall.

The question then is where does the revenue come from. A lot of people who are interested in leveraged buyouts have been by to visit me and to make the argument why any limitation on leveraged buyouts would hamper the functioning of the marketplace, et cetera, et cetera. But it would produce some revenue. I think that if we are going to talk about lowering the capital gains rate, all those people who want to protect leveraged buyouts ought to be very wary because that is a source of revenue to pay for a reduction in capital gains.

There are a number of other sources of revenue that will inevitably be looked at if we get seriously to the point of figuring out how we are going to pay for a reduction in the capital gains rate and the revenue effect that flows from it.

Mr. Chairman, this is an issue which it has been my experience has certain doctrinal religious significance. There are people who believed in and considered the 1986 act, if the tax rate was 10 percent, not 28 percent—and I know Senator Packwood remembers this—if it was 10 percent, there was an element of the population that believed there should be a capital gains differential.

Other people said, well, no, no, if you get the top rate down low enough—maybe where the capital gains rate was back in 1981—28 percent—the need for a capital gains differential would be less.

The latter argument carried the day. We got the rates down to 28 percent and now here we are back with the proposal to cut the rates to 15 percent for those who have capital assets as opposed to those who earn money from wages.

So, Mr. Chairman, this is an issue that we have been over in this committee at some great length, but it is far from resolved. But I will tell you that since another one final unwholly coalition out there, when George Bush floated the idea of reducing the capital gains rate, it on its face seemed peculiar—if not absurd—because of who the beneficiaries were, the revenue losses, the variety of other things that the proponents of the proposal will attempt to refute in this hearing today.

The response from some people was, well if you are going to go the capital gains road, you have to raise the individual income tax rates. Well that is the ultimate unwholly coalition, I believe. Where you decide you are going to give a dramatic cut in taxes for the top 1 percent of the population and you are going to pay for that by raising the individual income tax rates in the 1986 act.

So, Mr. Chairman, I would hope that we would look at this with a great deal of reflection and objectively. I do not really know if one hearing will be enough to get to all the bottom of this revenue dispute.

The **Chairman**. Thank you very much, Senator.

Let me give the arrival; we will follow that. It is Bentsen, Packwood, Bradley, Heinz, Chafee, Danforth. I know we have a number of witnesses waiting to testify.

Senator Heinz.

OPENING STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM PENNSYLVANIA

Senator **Heinz**. Mr. Chairman, thank you very much.

Mr. Chairman, as others have noted, this debate is more than just about a specific proposal by the President. Someone described the debate as being about whether there should be this particular proposal as a means of stimulating more capital formation. And as we will have time, I trust, to get into questions with our witnesses later today, I think there are some very legitimate questions that need to be asked—not just about the revenues, the winners and the losers, the narrowness of the proposal.

I think we all ought to keep in mind a couple of facts. One fact is that if you look at the international competitive environment that we are attempting rather unsuccessfully to make our way in—if the $130 billion trade deficit is any indication and if the problems of our industries of the future, such as high definition television are any indication—we have a very serious problem.

That is, this country for historical reasons I will not go into, has evolved a tax system that uniquely—and I mean uniquely—taxes returns to equity ownership to a far greater degree than any developed country that we compete with. Japan, Germany, Italy, France, England do not doubly tax returns to equity. They have methods of reducing or eliminating what has been called the double taxation of dividends, which is the return to an equity shareholder.

It is my view that this country needs to recognize that a country that is certainly no better off in terms of labor productivity, and which has no evidence to support the idea that we are any better off in terms of management capability and competence than our competitors, cannot survive in an international environment where our capital structure makes our firms economically uncompetitive because the cost of that capital in this country is prohibitively high.

So I hope that we will look more broadly at the issue of capital formations, of savings, of incentives for productive investment. I just make a point, we have recognized the need for some of this. That is why there is an R&D tax credit on the books. We have recognized that of all the investments business make that the most speculative, the highest risk, the longest term, is research and development. We have, unfortunately, however, very narrowly defined what that is. We have left out all the other aspects that result in applications—engineering and process change investment. And as a result, we are giving minimal recognition to the need for change of the time when we congratulate ourselves on doing it.

I hope that this debate will not simply focus on the issue here today of the President's proposal. It is a step in the right direction, even if we do not, perhaps, think the footprint is of the correct size and shape. But this larger issue will not go away unless we want to have the country continue to labor at a disadvantage.

The CHAIRMAN. Thank you very much, Senator.

Senator Chafee.

Senator CHAFEE. No comments. No statement, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Chafee.

Senator CHAFEE. I thought you might approve.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Oh I was thinking about saying something, but Senator Chafee did so well with the Chairman, I have no statement. [Laughter.]

The CHAIRMAN. I would ask, because of the number of witnesses we have and the interest in this, and because we want to get to the questions, that the witnesses limit their opening statements to 5 minutes. We will take the entire statement in the record and then we will get to the questions.

Senator Daschle.

Senator DASCHLE. I have no statement, Mr. Chairman.

The CHAIRMAN. We are delighted to have Senator—we did have him. Senator Bumpers, is he still here?

He looked at all those opening statements and took a walk. That is what happened to him. [Laughter.]

Is someone fleet of foot that was after him? Okay, fine.

Senator HEINZ. Senator Chafee, would you like to reconsider? [Laughter.]

Mr. Chairman, this is not very good for the C-Span coverage.

The CHAIRMAN. I thought that was the Republican Campaign Committee. [Laughter.]

All right. Is he here?

The famous words in the Senate always are, "The Senator is on the way, any minute."

Senator Bumpers, we eagerly await you. Let me forewarn you, because you may have stepped out of the room. We are limiting all statements to five minutes. We will take everything for the record and we want to open it up to questions afterwards.

If you would proceed, sir.

OPENING STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM ARKANSAS

Senator BUMPERS. Mr. Chairman, I would be happy to summarize my prepared statement and ask unanimous consent that the full statement be inserted in the record. It never occurred to me that a couple of Senators would forego an opening statement or I would not have dared do what I had to do anyway. [Laughter.]

The CHAIRMAN. That is explanation enough. [Laughter.]

Senator BUMPERS. Mr. Chairman, my capital gains bill, S. 348, is a "venture" capital gains bill. I cannot support the President's capital gains proposal for all the reasons that have been already well stated here. But I support the capital gains bill that I have introduced as do 11 other Democrats and 1 Republican. Let my emphasize that capital gains is not a partisan issue. There are more Democrats supporting a capital gains tax reduction in the Senate than there are Republicans and I expect to pick up a lot more Democrats and Republicans.

Mr. Chairman, I am a former small businessman, and chairman of the Senate Small Business Committee. Witness after witness comes before our committee every year and tell me year in and year out that capital formation is the uno numero problem for small business.

If you look at all the most successful biomedical and computer firms in the country, you will find that everyone of them started out as a very small business. Everyone of the executives will tell you they hung by a thread, hung by their thumbs, until they finally got enough capital to weather the startup period.

My venture capital gains bill is very simple. It is a realistic and responsible capital gains bill, that according to the Joint Taxation Committee, will cost $500 million in lost revenue over a 5-year period. Taxpayers receive a tax break if they buy stock issued by a new company and hold it for 4 years. This tax break does not include trading of the stock in the secondary markets. It only includes stock issued by companies whose capital formation require $100 million or less.

Incidentally, the bill I introduced last year had a capital formation threshold of $10 million. It does not cost all that much more in lost revenue to raise the threshold to $100 million, according to the Joint Tax Committee, so this year I raised the threshold.

The Joint Committee says that the President's bill will cost $24 billion in lost revenue over a 6-year period, so he needs to revise his bill. There is a figure that just makes it totally out of the question from a deficit standpoint to consider his proposal.

My bill only includes original issues by a startup company with $100 million or less in paid-in capital . It only involves direct purchases of that stock from the entrepreneur.

And this tax incentive is not retroactive. One of the most objectionable things about the President's proposal is that it is retroactive. If I bought stock last year, knowing full well that there was going to be no capital gains advantage, and that stock has doubled in value, under the President's proposal I can still take advantage of the new gains rate even though I did not anticipate that kind of a windfall.

My bill is prospective only. There is nothing retroactive in it. It confers no windfall.

Finally, it also does not abolish the obligation to pay a minimum tax.

Several Senators will not co-sponsor my bill, Mr. Chairman, because they said subjecting people who buy stocks for this purpose to the minimum tax of 21 percent and setting the gains tax rate of 21 percent is not a big enough incentive when you add the 4-year holding period to it. It is not a big enough incentive to get people really interested in venture capital investments. So I have gone back to Joint Tax and asked them about the revenue cost if we reduced that gains rate to 15 percent, which is what the President's rate is, and eliminate the necessity of including the excluded gains in the minimum tax.

The reason I left the minimum tax intact was because that was one thing about the 1986 reform that I thought was a dynamite idea and I was just reluctant to excuse anybody from it. But if we are really serious about trying to help small business—we are talking about venture capital for small business—it may make sense to set the gains rate at 15 percent and not apply the minimum tax and make it a more powerful incentive.

One of the things that did happen with the tax reform law is that when you abolish capital gains you also abolish the holding period. People have a tendency to get in and get out of an investment. There is no holding period. So you make an investment and, the minute you have a gain in it, you sell it. That is one of the things, of course, that mitigates in favor of my bill. It does set a long holding period. One of the bad things about the get-in-get-out approach to investments is that small businesses get left in the starting blocks.

Nobody is going to invest in a small business startup company when they can go invest in IBM, know they are going to make 10 to 15 percent the next year, and pay a 28-percent tax on it, or maybe a 33-percent tax, or whatever.

Mr. Chairman, I see the yellow light on, so I just want to finally say that everyone finds that the jobs in this country, that more than 56 percent of the jobs in this country, are created by small business. Some say the correct figure is 80 percent. Nobody quarrels with the fact that small businesses have to be small before they can get big. If you go down the Fortune 500, from Apple to Microsoft, you name it, everyone of them started out small, screaming, pleading for capital to try to generate growth and sell a good idea.

If you talk about the trade deficit, which Senator Heinz has alluded to correctly in his analysis of all of this, we have got to come up with better ideas and we have got to sell those ideas. And the best way in the world to do that is to give an incentive to the people who have those ideas to begin with, namely small businesses.

In that connection I might just say, I spent three hours at the National Institutes of Health yesterday afternoon, Mr. Chairman. Since so much of what they do really relates to this committee's work, every member of this committee that has not done that ought to go take advantage of the experience I had yesterday afternoon. I heard them say that they have lost 28 percent of all their senior scientists in the last 6 years and in that same period have not been able to recruit one single replacement. The problem also is almost every one of those people is going out to join or start small business concerns with an idea they'll need capital.

So, Mr. Chairman and members of the committee, for all of those reasons, when you consider the minimum revenue cost and the importance of capital formation for small businesses. I think it makes an awful lot of sense for this country to pass my bill.

The CHAIRMAN. Thank you, Senator. Your entire statement will be taken into the record.

I know the job you are doing on small business and your deep interest there. I share that with you. Much of the strength of this country comes from creation of small businesses. The vast majority of them fail; very few succeed. It is certainly not more than 1 out of 5. But I have seen an interesting transition take place in the sources of venture capital—a move away from individual investors to pension funds. Your bill provides no particular incentive to tax exempt pension funds does it?

Senator BUMPERS. There is no incentive in my bill for tax-exempt investors. My bill is totally irrelevant to them. Now, the one thing we do, Mr. Chairman, is we do—unlike the President—allow corporations, as well as individuals, to make venture capital investments and take advantage of the capital gains incentive.

The CHAIRMAN. So it does give a corporate tax incentive?

Senator BUMPERS. It does. It includes corporations. There are a lot of corporations who would be willing to put a few bucks in a startup business that they think is a little dicey, but they do not want to put the total amount of money up to do it themselves. That is a very common thing in the corporate world.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Are there other questions of the witness?

Senator CHAFEE. Just one quick question, Mr. Chairman.

Senator Bumpers, I am not sure I got your point about the NIH. I assume, obviously, the salary limitations has been a deterrent for them to keep their folks. But it seemed to me what you are saying is that, many of them have gone out into small businesses. Does that not mitigate against—contradict your point—that under the current situation, they are still going out to form small businesses despite the lack of a capital gains differential?

Senator BUMPERS. Well, I simply want to make the point that salary is one of the big deterrents in why NIH employees are leaving.

Senator CHAFEE. Well, I certainly think—and I personally think—it is a disaster what we are doing in this government, not giving that salary increase to the judicial, and particularly, the executive. But that is a separate subject.

Senator BUMPERS. It is and I say I agree totally with you in believing that it is a disaster for NIH and the government. On the other hand, the country is not losing the services of those people totally because many of them are going out and starting their own businesses with an idea they have in the biomedical field. Some of them are joining small businesses that are still groping and trying to get ahead. They are going out there in part because they are taking stock options and so on, and they have an opportunity to make some pretty good money off an idea.

Senator CHAFEE. Well, I guess my point was that it is still going on despite the fact that we eliminated the capital gains differential in 1986.

Senator BUMPERS. I would rather retain them at NIH, Senator.

Senator CHAFEE. Oh, yes.

Senator BUMPERS. I think it is terrible that we do not raise their salaries out there so they can recruit and keep these people. But as I say, that is sort of extrinsic to this debate. I guess what I am saying is, there are so many great ideas in the biomedical field and in the computer field, as well as other scientific fields. There are so many great ideas, right now, that are going begging for lack of capital. All I am trying to do is add some small incentive to give those people a boost and give them a hand.

Senator CHAFEE. Okay. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Any others?

[No response.]

The CHAIRMAN. Senator Bumpers, that is a very interesting and intriguing proposal. We appreciate your bringing it to us.

Senator BUMPERS. Thank you very much, Mr. Chairman and members of the committee, for allowing me to testify this morning.

[The prepared statement of Senator Bumpers appears in the appendix.]

The CHAIRMAN. Our next witness will be Mr. Dennis Ross, Deputy Assistant Secretary for Tax Policy, Department of the Treasury.

Mr. Ross, we are pleased to have you. If you would summarize and make your statement within the 5 minutes, we will take your entire statement in the record. Then we will open it up to questions.

STATEMENT OF DENNIS ROSS, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. Ross. Thank you, Mr. Chairman. I will attempt to summarize my full written statement.

I appreciate the opportunity to speak with you today about the administration's proposal to reduce the rate of tax on long-term capital gains. The President's budget for fiscal year 1990 includes a number of revenue proposals but none that is more important to the continued health of economy and to the Nation's future competitiveness.

In my testimony today I will explain the tax and economic policy objectives that support the proposal and how the proposal relates to and is, in fact, consistent with the objectives of tax reform.

I will also explain the basis for our estimate of the proposal's revenue effects. We recognize that this aspect of debate over the proper treatment of capital gains is highly controversial. We accept, moreover, that reasonable minds can differ over the revenue effect of a cut in the capital gain tax rate.

At the same time, we believe that a careful review of the available evidence supports Treasury's conclusion that the proposal raises revenue both in the budget period and in the long run. Accordingly, we have supplied an unprecedented amount of information concerning the basis for our estimate. And if these hearings produce no more than a careful examination of the issues involved in estimating the revenue effects of a capital gain rate reduction, we will have advanced the debate over an important issue of tax policy. I believe we will have also increased the chances that a capital gain preference will be restored.

Mr. Chairman, let me start by simply briefly summarizing the basic elements of our proposal. We propose a 45-percent exclusion and a 15-percent maximum rate on long-term gains and certain qualified capital assets. Qualified assets under our proposal would generally be limited to assets defined as capital assets under current law. This would effectively exclude depreciable and depletable assets from the capital gain preference. We would also exclude collectibles from the capital gain preference.

In order to receive the preference, assets would have to satisfy a holding period requirement. Initially that would be set at one year. But over a phase-in period, it would be extended ultimately to three years. A special 100-percent exclusion, effectively a zero tax rate, would be provided for long-term gains of taxpayers with less than $20,000 of income.

With that brief summary, let me turn to the policy reasons which we believe support our proposal. In our view, restoration of a capital gain preference will have a number of positive effects on the economy and on our collection of revenues. The importance of a capital preference as an incentive for investment has long been recognized in this country and also abroad. From 1922 until 1987, our system continuously supplied some form of preference for capital gains. Despite our elimination of that preference in the Tax

Reform Act, our major trading partners all continued to extend preferential treatment to capital gains—with some, in fact, exempting capital gains entirely from tax.

The administration's proposal would further target the incentive effects of the capital gain preference to long-term investment. Currently, investors receive the same tax treatment whether they hold an asset for 10 years or for 10 minutes. If this country is to maintain its leadership role in the world economy, we need to encourage investment and in particular investment that is oriented to long-term growth, rather than short-swing speculation.

By orienting investors more towards the long term, we will also enable and encourage corporate managers to take the long view of their company's businesses and to make the investment in research and development that is needed for success in future markets.

Mr. Chairman, in addition to capital gain preference, it would also mitigate what is commonly referred to as the lock-in effect of current law. Under a system in which capital gains are not taxed until realized, a substantial tax on capital gains tends to lock taxpayers into their existing portfolios. In effect, taxpayers may elect a zero rate of income tax on their gains by simply retaining their investments. The higher the statutory rate of tax on capital gains, the more likely that taxpayers will make that election—that is, elect to pay no tax by simply retaining their investments.

This lock-in effect results in a misallocation of capital in the economy since it alters the investment decisions that would be made in a genuinely free market. It also deprives the government of revenue in our view. To the extent taxpayers avoid sales of existing investments, taxes that might otherwise have been paid are deferred or a voided altogether.

The combination of these two effects produce a situation in which both the taxpayer and the government lose. The taxpayer is discouraged from pursuing what he believes is a more productive investment and the government loses revenue.

Finally, Mr. Chairman, a capital gain preference would provide a rough adjustment for the overtaxation of capital gains that occurs under current law on account of inflation. Because of inflation, every capital gain includes a fictional element of profit attributable not to an increase in the value of the capital asset, but instead to the decline in the value of our currency.

Taxing capital gains in full has the perverse effect of overtaxing real gains, understating real losses, and in some cases taxing nominal gains that are, in fact, real losses. We recognize that capital gain preference is not a perfect response to the problem of inflation. It does, however, provide a rough adjustment for the effects of inflation and avoids the complexities that would entail a more precise form of accounting for the effects of inflation.

Mr. Chairman, let me turn briefly to the question of revenues. As I stated earlier, we recognize this a controversial aspect of the debate over capital gains and different studies of the problem have produced very different results.

Our estimate was made after a careful review of empirical studies by experts within the government and in the academic community. Our estimate attempts to approximate a consensus from that admittedly wide range of results. And before presenting the detail of our estimate, let me simply make one point about its source. The revenue estimates reported in the President's budget were produced by Treasury's Office of Tax Analysis. This is the same office that produces revenue estimates for the administration on budget proposals and legislative proposals.

You may have seen reports in the press that other offices in Treasury determine these estimates, or that the Office of Tax Analysis produced them only with the proverbial gun to its head. Whether those reports are the product of misinformation or fevered imagination, let me assure you that they are simply wrong. Although there has been a debate for some time at Treasury as to the proper basis for estimating the effects of a cut in the capital gain rate, the simple fact is that our estimates—the estimates in the budget—reflect the same basic assumptions that the Office of Tax Analysis has employed for a number of years in analyzing capital gain proposals.

The CHAIRMAN. I will ask you to summarize now, Mr. Ross.

Mr. ROSS. Okay.

Well, the summary would simply relate to the revenue effects of the proposal and our breakdown of those revenue effects. The best way to summarize that, Mr. Chairman, is simply to point you to table 3, which is attached to our testimony, and provides a line item breakdown of the separate components of the proposal. It leads you through the basis for our analysis which has a number of components.

I will not take, I guess, time now to lay those out in detail. It is in detail accounted for in my written statement.

[The prepared statement of Mr. Ross appears in the appendix.]

The CHAIRMAN. Well, let us get to the questions. Thank you.

Mr. ROSS. That is fine.

The CHAIRMAN. All right.

Tell me what the difference in assumptions was in 1986. Because I am sure you were faced with a question of what you did—what Treasury did, I should say—in 1986, when it said that raising the rate from 20 to 28 would pick up $21 billion over 5 years. And now, you come in and say if we lower it from 28 to 15, we will pick up $16 billion over 5 years.

On the surface, that certainly appears to be a contradictory result. Would you explain that to us?

Mr. ROSS. I will, Mr. Chairman. I understand the basis for the question. There is, what I think is, a superficial appearance of contradictory results.

The basic methodology for the two estimates is——

The CHAIRMAN. Well, it looks like a lot more than superficial. Also, can you explain to us your version of it.

Mr. ROSS. This hearing can perhaps shed some light on that. Let me explain to you why I think it is simply a superficial contradiction.

There are really two elements at work here. The first is that our proposal is not simply a reversal of what was done in 1986. If you go back to the law before the Tax Reform Act——

The CHAIRMAN. It is more selective.

Mr. ROSS. It is a targeted proposal, focusing both on assets with a longer holding period and in a certain category of assets—principally, as a practical matter, corporate stock—depreciable assets, depletable assets, and collectibles are excluded. The effect of those two changes—the 3-year holding period and the targeting toward a more selective class of assets—improves the revenue effect of the proposal. In our view, those assets are less responsive to change the assets that we have excluded from the proposal.

The CHAIRMAN. May I ask you about non-depreciable real estate. Is that included or excepted?

Mr. ROSS. Raw land would, itself, be included in the proposal since it is not depreciable.

The CHAIRMAN. Nondepreciable, all right.

Mr. ROSS. But buildings, structures would be excluded.

Again, our data indicates that depreciable assets are less likely to be sold in response to a change in the tax rate. Ordinary business reasons are more likely to dictate the timing of sales. The consequence is that, if you extend a capital gain preference to those assets, you tend to lose more from the reduction in the rate than you will gain from increased realizations in response to the lower rate.

We, again, find that not to be the case with respect to corporate stock and the other assets——

The CHAIRMAN. I would think that person would have a double hit. He would have taken advantage of depreciation and then gotten a lower rate in addition.

Mr. ROSS. There is that element, too. As you well know, the basis for tax shelters prior to 1987 tended to be the availability of cost recovery in the front end, which could generate tax losses, and then capital gain on the back end.

The CHAIRMAN. Let me give you another one. One that is worrying me is what appears to be a churning of stocks—a tremendous turnover. Let me give you an extreme example of it.

I looked at the report the other day in the paper of this West Virginia Employees' Pension Fund. It had about $2 billion in assets; it had over $80 billion in trades last year. That is incredible. And in the process it lost a couple of hundred million dollars.

I read Warren Buffet's comments about trying to stop the churning. He goes to the other extreme. He talks about a 100-percent penalty in the first year.

Has any thought at all been given to some kind of a penalty—not 100 percent—in the first year to try to slow down the churning and then a reduction of the tax, as you have stated, to try to encourage holding the asset?

Mr. ROSS. We did consider proposals along that line. I can understand why you would be interested in them. I think our view was that, an actual higher rate of tax on short-term capital gains would be a difficult matter for many activities that simply in the nature involve short-term transactions—that what you are really concerned about is trying to sort out pure speculative investment from what we think is more productive long-term investment.

That is not really an easy matter to do. I think, though, that a preferential rate based on an extended holding period moves in that direction. It is more carrot than stick. If you added a short-term penalty rate, you would be adding a stick. But by providing a substantial carrot for those willing to hold for as much as 3 years, I think you do address in a significant way the problem of churning. It is not going to affect pension funds but for taxable investors——

The **Chairman**. No, no. They do not have the tax problem.

Let me ask you, you were talking about our trading partners and their having a preference for capital gains. Give me some examples as to the countries and the rates.

Mr. Ross. I do not have the exact rates in my head. We could easily supply you with that information. In fact, my written testimony does not give exact detail.

[The information referred to above follows:]

INFORMATION SUPPLIED BY TREASURY, REQUESTED BY SENATOR BENTSEN

In Canada, one-third of capital gains are excluded from income. (Beginning in 1990, only one-quarter of gains will be excluded.)

In Japan, the tax on capital from sales of stocks equals, at the taxpayer's option, 26-percent of the fain (including a local tax) or 1-percent of the sales proceeds. Capital gains from sales of bonds are generally exempt.

In the United Kingdom, capital gains (adjusted for inflation) are generally taxed at a 30-percent rate.

In Germany, long-term capital gains (generally 6-month holding period) are tax exempt.

In France, capital gains on stocks are bonds are tax exempt when annual sales proceeds are less than a threshold amount (about $40,000).

In Belgium, Italy, and the Netherlands, most capital gains are tax exempt.

Mr. Ross. Our study that we published in 1985 has a table that essentially sets forth the basis on which capital gains are taxed in our major trading partners.

The **Chairman**. Then tell me why you think they have an advantage if they have lower capital gains rates.

Mr. Ross. I am not certain that they have an advantage taking the entire tax structure into account since I think the question——

The **Chairman**. I am not talking about the entire tax structure. I am talking about on capital gains.

Mr. Ross. Well that piece does give, I think, an advantage. Since they are saying to their investors, we are encouraging you to make capital investment—to save, to invest. To the extent it focuses on long-term investment, we are encouraging them to make long-term commitments of capital. I think that is an important element. I mean, it is recognized in our trading partners; it was recognized in this country for some 65 years. We are urging that it be reconsidered at this time.

The **Chairman**. Thank you.

Senator Packwood.

Senator **Packwood**. Did you pick the 15 percent number and run the estimates or did you run the estimates and come up with 15 percent?

Mr. Ross. Fifteen percent was picked for us, I must concede, by the President.

Senator **Packwood**. So there is not necessarily any statistical magic to it?

Mr. Ross. Well, not in terms of the revenue effects, no.

Senator **Packwood**. We might do better at 10 percent.

Mr. Ross. It is conceivable.

Senator **Packwood**. Maybe 20 percent.

Mr. Ross. Yes, we did not attempt to find a revenue maximizing rate.

Senator Packwood. Well, basically, it is a figure plucked out of the air that you then ran the estimates on to see what it might produce?

Mr. Ross. Well, plucked out of the air might be extreme. I do not what to characterize the President's decision that way.

Senator Packwood. All right.

Mr. Ross. But it was his decision. [Laughter.]

Senator Packwood. The second question. For all of us who go home to our coffee shacks, we used to get asked—not as much any more—about a Treasury or IRS story that 442 people made over half a million dollars last year and paid no tax. We go into the coffee shack where the person is making $18,000 or $20,000 and paying maybe $300, $400, $500 in Federal income tax and they are outraged. They say, "How can that happen?" And you say, "Well, they bought municipal bonds, which kept your school rates down or they donated a painting to the Metropolitan Museum, or they had capital gains."

I mean, almost all of it was legal. None of it was a rational answer as far as the sawmill worker was concerned.

So we strengthened the minimum tax and we said in essence no matter how fair the preferences may be or how desirable the social action you undertake, you are going to pay some tax. Your capital gains proposal is a step away from that concept—away from the perceived fairness by the $18,000 to $20,000 a year sawmill worker, is it not?

Mr. Ross. I do not think it necessarily is. When you get into the question of perception, it is hard to say what the percent would necessarily be. Certainly there is a lot of argument that a capital gain preference benefits the wealthy. We think that argument is ill-founded and in part for the reasons you suggested in your opening statement. We think the effect of the preference is to increase tax payments by the affluent.

Senator Packwood. It is interesting. It is not so much that it might benefit the wealthy. The story is that they pay no tax at all. And we could have gone one of two ways. We could have, in Tax Reform, tried to figure out, let us get rid of all the preferences.

Mr. Ross. Right.

Senator Packwood. We just said, no, just keep them but say there is going to be a minimum tax. It was an easier way to go. But it is important, if the public is going to support this system, that we do not go back to something that will allow people of immense wealth to escape paying any taxes.

Mr. Ross. No.

Senator Packwood. And then you or IRS—I cannot remember which—put out the stories that they did not pay any taxes.

Mr. Ross. No, this proposal would not have that effect. We would intend, in the context of the minimum tax, you would include the full capital gain, but it would effectively be capped at a 15 percent rate. So whether under the regular tax or the minimum tax, the maximum affective rate of tax on your capital gain income would be 15 percent.

Senator Packwood. Now why have you excluded timber?

Mr. Ross. We did not make a specific decision about putting timber in or out; oil and gas, in or out; and a number of other assets in or out. We made a general judgment that depreciable and depletable property, business assets, ought to be out.

Senator Packwood. Why?

Mr. Ross. That was based on a number of considerations. One is what I went through a bit in my statement about the responsiveness of those assets. A second consideration is that, if you want to provide an incentive for those assets, and many think we should, a more, I think, consistent way to do it and one that the system has generally followed historically is through the cost recovery system. There are a variety of rules under current law that provide special cost recovery treatment for depreciable and depletable assets. And to some extent, adding on top of that a capital gain preference provides an additional extra benefit.

I think it is important to recognize, though, that timber and other particular activities are the beneficiaries of this proposal, to the extent those activities are conducted in corporate form. What we are saying is that, we do not extend the preference to direct investment, non-corporate investment, in those activities. I do not think that creates an unlevel playing field—a disadvantage for timber.

Currently, the corporate investor phase is a disadvantage because as Senator Heinz well stated, we double tax corporate income—at least in form. And that creates a tax penalty for activities conducted in corporate solution. This mitigates, not completely, but some of that penalty. I think it moves the system as a general matter closer to a level playing field.

Senator Packwood. What is the advantage to capital formation from including homes?

Mr. Ross. For including homes?

Senator Packwood. Yes.

Mr. Ross. Well, I do not think you can explain that in terms of capital formation or business incentive. Those assets are nondepreciable and it was on that basis that the decision was made. Again, we made a general judgment—depreciable property is out; nondepreciable is in—and homes fell on the inside of that line. If you wanted to focus just on productivity, I think you could have made a different judgment.

Senator Packwood. Any possibility that politics might have been involved in leaving homes in?

Mr. Ross. It might have been involved in confirming our decision about depreciable versus nondepreciable, but it was not approached as a separate issue.

Senator Packwood. Thank you, Mr. Chairman. I have no other questions.

The Chairman. Senator Bradley.

Senator Bradley. Thank you very much, Mr. Chairman.

Mr. Ross, I was intrigued by the proposal that you would forgive entirely capital gains for incomes under $20,000. What was the rationale behind that?

Mr. Ross. Well, there were a couple. You find—at least the data indicates—that taxpayers at higher tax rates tend to be more responsive to changes in their rates. At lower rates, a comparable percentage exclusion has less bang for the buck in terms of motivating taxpayers to invest. One of the consequences of that in our view was that a 45-percent exclusion would not necessarily provide a substantial incentive for lower income taxpayers to invest. And in the search for a more substantial incentive we went all the way to 100 percent.

I think it was an attempt, frankly, to try and balance perceptions of the fairness of the package. It was intended to say, this is not simply a provision that benefits wealthy investors; it also benefits low-end investors.

Senator BRADLEY. Why $20,000 as opposed to $30,000 or $40,000?

Mr. ROSS. Well, you could have chosen a higher figure. That, in part, was influenced by our sense of what we could afford to spend in that direction. Providing that incentive for that group of taxpayers is a revenue loser in the context of the proposal—I think on the order of $300 million a year. To the extent you take that up significantly, say to $30,000, the revenue costs goes up significantly as well.

Senator BRADLEY. So that anybody that earns under $20,000 a year does not have to pay any capital gains, is that right, on the sale of an asset?

Mr. ROSS. On the sale of an asset. That is correct.

Senator BRADLEY. Well, then——

Mr. ROSS. I should not say anybody. I mean we contemplate possible anti-abuse rules in some context.

Senator BRADLEY. Let us talk about that a minute. What about the person who has an income primarily from interest on municipal bonds and has got a lot of land out there, and decides in one year he is going to make a sale of land and make $10 million, but his income is under $20,000. Is that person excluded from paying capital gains on a $10 million land sale?

Mr. ROSS. That is something that I think could be considered. What we have said, specifically, in the context of the proposal is that, if you are on the alternative minimum tax—even if your reported income is $20,000—you would not be eligible for the $100,000 exclusion. To the extent we were not satisfied with the minimum tax inclusion of tax-exempt interest which is limited to newly issued industrial revenue bonds and not general obligation bonds, perhaps we could expand that concept to say that if you are getting a substantial income from tax exempts you also should not get the preference. I think that would be consistent.

Senator BRADLEY. In the proposal that you have put to us, that person would not have to pay a capital gains tax?

Mr. ROSS. Yes. I am also reminded that the capital gain, subject to the exclusion, would also count toward the $20,000. So there is some limit on the benefit you could get out of this, even if all of your income was otherwise in a form that was not recognized for tax purposes.

Take your case of someone who had —a Mrs. Dodge, who is always the historical example, someone who had all of her income in the form of tax exempt——

Senator BRADLEY. She is a New Jersey resident. Pick another one. [Laughter.]

Mr. ROSS. Mrs. Buick, or somebody.

The proposal would say that to the extent capital gain income itself moved you above $20,000, you would not be eligible for the preference. We would allow the 45 percent exclusion against capital gains to count for that purpose. So, in effect, if you had no other income, a capital gain of $40,000 would effectively knock you out of the preference.

But I think there might be more general sort of anti—abuse is too strong a term—but rules designed to target the preference toward truly low- and middle-income taxpayers.

Senator **Bradley**. Now on the question of revenue, there have been a number of studies done on revenue—and there were a number of studies done prior to the 1986 act.

Mr. Ross. Yes.

Senator **Bradley**. What would be the capital gains realized there was no 1986 act?

And then there were a lot of people that made projections on the total capital gains realized if there was a 1986 act and I would like to just share with you the projections. If there was 1986 act, the base line capital gains realized in 1987 was projected to be $177 billion. Now the Feldstein-Slemrod model said that if you do the 1986 act, the capital gains realized is going to drop to $37 billion. The Treasury said it would drop to $55 billion. Claudfelter said it would drop to $97 billion. When, in fact, the actual number is $136 billion.

So the question is, you know, how can you possibly say that you are going to gain revenue when you were off in 1986 by about $100 billion? That is a pretty big difference.

Mr. Ross. Well, I am told by one of my staff here that—I am not sure of the source of the $55 billion figure. Let me respond to the general thrust of your comment. I think there have been mistakes in predictions about capital gain behavior, but not only in that direction.

A lot of people way underestimated—Treasury and the Joint Committee—the effect of taxpayers selling assets at the end of 1986 to avoid a higher rate of tax, which is some suggestion about the level of behavioral response to a cut in the capital gain rate. They responded quite powerfully in the face of a higher capital gain rate. We were quite low in our estimate of that. The response of the Joint Committee, for example, was even lower.

I think there is a history of difficulty in estimating these behavioral effects and we cannot assert that our estimate today is, you know, divinely revealed wisdom. It is our best attempt.

Senator **Bradley**. Why is it within $100 billion?

Mr. Ross. I am not sure.

The **Chairman**. The time has expired and we have several who want to ask questions.

Senator Heinz.

Senator **Heinz**. Mr. Chairman, thank you.

Maybe I missed something in the discussion so far, Mr. Ross, but it really goes back to a question Senator Packwood asked at the beginning that I do not think he followed up on, which has to do with your revenue estimates if we take them at face value.

They say that over the 11 year period—1989 through 1999—there will be a net revenue loss of $200 million, or about $20 million a year, on average. Now it isn't, of course, smooth and even. But the bottom line is, in terms of revenue loss, there is not any revenue loss that is significant; there is not any revenue gain that is significant if we take your numbers at face value.

My question is, if one of the reasons to reduce the capital gains tax is to enhance capital formation and competitiveness by increasing the return to capital investment, and your proposal does not cost anything, how can it increase the returns to equity?

Mr. Ross. In fact, our proposal—the 10-year numbers we put out are a little misleading. Since, as you noted, they take you through a fairly bumpy period of revenue effects. There are initial positive revenue effects.

Senator Heinz. I realize that.

Mr. Ross. A period where the revenues fall off.

Senator Heinz. Let me rephrase the question if you would prefer. In the short run it raises money——

Mr. Ross. And how can that have a positive effect on——

Senator Heinz [continuing.] And how can that have a positive effect on capital formation if you take more capital away?

Mr. Ross. Well, in one sense you are clearly collecting more tax revenue; but you are doing two things. You are improving the allocation of capital within the economy.

Senator Heinz. How?

Mr. Ross. Well, there are two effects there. One is by abating some of the penalty tax we applied at corporate investment; and leveling the playing field in that sense, you improve the allocation of capital. The second is by allowing investors to make more market-oriented decisions, less tax influenced decisions. In other words, taking the tax wedge, in a sense, away from or at least reducing the tax wedge they face when they decide whether or not to sell on the asset. You move more toward a market system of investment decisions which improves the allocation of capital.

Beyond that, you are telling taxpayers that they face, in fact, a lower rate in terms of their investment decisions. Behaviorally, I think, taxpayers respond positively to a lower rate even if the effect as a practical matter is that they will sell more and pay more taxes to the government. You are still holding out a carrot to them which I think will have the general effect of increasing investment.

Senator Heinz. If the goal is to have some kind of greater neutrality—let me quote from the 1984 Treasury Department Report to the President on Tax Reform, which recommended repealing the capital gains tax rate differential coupled with indexing for capital assets.

And the reasons for that proposal were, and I quote:

> The current preferential tax rate for capital gains has often been justified as an allowance for the overstatement of capital gains caused by inflation. The preferential rate actually serves this purpose only sporadically. The effects of inflation accumulate over time, yet the preferential tax rate does not vary withholding period of an asset or with the actual rates of inflation during such period. As a result, the preferential tax rate undertaxes real income at low rates of inflation and overtaxes capital gains at higher rates of inflation. For any inflation rate, the longer an asset is held, the greater is the undertaxation of real income.

Moreover, the preferential rate does not prevent taxation of inflation caused nominal gains in circumstances where the taxpayer has, in fact, suffered an economic loss.

That is the Treasury Department's own report.

Now, as you know, I am very interested in finding a way to improve the competitiveness of this country, as I spoke at the outset. And I think it is important we find a way of increasing returns to capital. I would like to see us do so in a way that does not create the problem that Senator Packwood referred to in his round of questioning—namely, upsetting the income distribution of tax benefits curve so that we do not get those stories again that wealthy people are not paying their fair share of taxes.

Let me ask you this. One of the justifications of the administration provides for restoring capital gains exclusion is that the reduced rate mitigates the effect of inflation, would not the best approach really be to provide indexing?

Mr. Ross. Well, indexing has a lot of conceptual merit. But it is deficient in a couple of respects. I had a hand in writing the passage the you were reading. So I am familiar with what was in there.

Senator Heinz. I thought it was well done.

Mr. Ross. Thank you very much.

Indexing is plainly the correct way to deal with the problem of inflation. It does entail some complexity though, both for taxpayers and for tax administrators. I think that is a negative. Beyond that, it does not really address what I have referred to as the "lock-in" effect. The fact that a taxpayer is still electing whether or not to pay any tax by electing whether or not to sell his asset. Now an indexing system might mitigate a bit of that. But it, frankly, does not do it to the same extent as a capital gain preference.

In that sense, a capital gain preference does have significant advantages over a mere indexing proposal.

Senator Heinz. Thank you.

I think my time has expired. Thank you.

The Chairman. Senator Danforth.

Senator Danforth. Mr. Secretary, in January we held hearings in this committee on the question of leveraged buyouts and Secretary Brady testified at that time. A number of witnesses pointed out that one of the things we have done is to stack the deck in favor of debt financing and against equity financing. The restoration of a capital gains differential would help make equity financing more attractive, would it not?

Mr. Ross. Plainly.

Senator Danforth. If the LBOs are a problem, that would be one way of getting at the problem?

Mr. Ross. It directly reduces the tax disparity and the treatment of debt and equity and in an important way.

Senator Danforth. The administration favors both dealing with the double taxation issue and restoring a capital gains differential. If you had to pick one of the two, could you do it or is this still a matter of debate within the administration?

Mr. Ross. Well, no, I think certainly in terms of the current year and near term legislative agenda, capital gain is the direction in which the administration is pushing. And again, I think as you noted, it tends to achieve both the general positive effects on capital investment and also some of the disparity between debt and equity.

Senator DANFORTH. Senator Bumpers idea is to distinguish between new issues and existing issues. Is that a good idea?

Mr. ROSS. Well, I can see the basis for it. I think it has a number of problems. It is hard, frankly, to prevent people from retiring old stock and then reissuing it; and, in fact, trying to come under the preference in that way. There is some administrative problems in trying to limit a proposal to new issues of equity.

You also need to recognize that the existing stock of equity faces the same lock-in effect, and misallocation of capital results, as an new equity investment would over time. And for that reason, I think there is a policy basis for extending capital gain preference to old as well as new equity investment.

Beyond that, we ought to recognize that we have always treated changes in the capital gain rate on a retroactive basis. Investors who made decisions before 1986 thinking they were going to face a 20-percent rate of capital gain tax woke up on January 1, 1987 and realized they faced a 28-percent rate. There was no attempt at that to say, let us just apply this prospectively.

It seems to me you would have a real fairness argument with taxpayers who invested at the time of the lower rate in telling them that when a preference is restored they are under the rules that were adopted in 1986, even though they may have invested in 1985 or before.

Senator DANFORTH. Is the technical problem insurmountable or is it——

Mr. ROSS. In terms of new versus old equity?

Senator DANFORTH. Yes.

Mr. ROSS. It is difficult. We spent a lot of time thinking about that when we were working on Tax Reform at Treasury. It is very difficult. There is a long project that addresses the problem in part that has been produced in at least draft from by the American Law Institute, and it entails just a number of complexities that are, in our judgment, probably best avoided.

Senator DANFORTH. Some people believe that at the time of the 1986 Tax Act we had put so much emphasis on rate reduction that the effect of it would be to make venture capital much harder to get, it would create a phenomenon of people looking at short-term returns rather than the long-term investment that would have a negative effect on the future of the country because we would not be making the decisions to invest in the future of America.

Has this concern been borne out or was that simply a theory at the time?

Mr. ROSS. I do not know that there is data available to tell you directly whether it has been borne out. I mean, I certainly would argue at least on an individual basis—and I think this would be the administration's position as well—that the overall effect of Tax Reform has been very positive. But at the same time, I think we are making an argument that you could improve upon it and help with what I think is a problem, an excessively short-term perspective—both for investors and the companies in which they invest—by providing a direct incentive for long-term capital investment.

Again, I do not want to denigrate the effects of Tax Reform, which I think was a very, very positive step forward. But I think in this respect it can be improved upon.

Senator DANFORTH. The administration wants to extend the R&D tax credit and you want capital gains differential restored. You would like, if you could, do something about double taxation of corporate dividends. I take that to mean that the administration would like us to pass a tax bill this year.

Mr. ROSS. Well, yes. That is right. We would. The budget contains a list of tax proposals we would like to see included in it.

Senator DANFORTH. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

Secretary, I just want to clarify something you just said in response to one of Senator Danforth's questions relating to Senator Bumper's proposal. You said that one of the reasons that it causes you some concern is that we have always done capital gains changes retroactively. Were you citing that as a reason or a fact? I mean, it seems to me that having done things in the past consistently is really no reason for doing them in the future in the same way. But I may have misunderstood your answer.

Mr. ROSS. No, I did not mean to make a point that we were bound by precedent. But I think as a matter of fairness, many taxpayers invested at a time when there was a capital gain preference. They found themselves again in 1987 with capital assets that were not the beneficiaries of a preference. To restore that preference now and then say it only applies to new investment I do not think is consistent with what Senator Bumpers was trying to argue, that you are essentially providing a preference to people who did not anticipate it at the time they made the investment.

Senator DASCHLE. This may be solely for my own education. But I find table 3, and many of the tables you submitted with your testimony, interesting if for no other reason than, as Senator Bradley's question brought out, you have missed the mark, obviously, and you would be expected to miss the mark on projections. But, given the fact that we all understand that you will likely miss the mark for no reasons that you can control necessarily, why on tables such as this would you actually come up with projections that take you to decimal figures—$21.8 billion, $21.5 billion? Is that done for—and I do not mean to be facetious here—but is it done for——

Mr. ROSS. I understand.

Senator DASCHLE. What reasons are there for doing it that way?

Mr. ROSS. Well, it is really a matter of convention. It may overstate the precision—It does overstate the precision behind these figures. We do it. The Joint Committee does it. Everyone who has to supply estimates for purposes of legislation—the budget effectively——

Senator DASCHLE. But is that again a reason for doing it or is that just fad?

Mr. ROSS. Well, I mean, I would I guess be willing to entertain a proposal that we round to the nearest billion. [Laughter.]

It does overstate the precision of the estimates. You are quite right about that.

Senator DASCHLE. I think it would be a good idea. I mean, I do not know nearly what you know about many of these projections. I just know that you are never going to be down to a decimal figure, especially when considering 1999.

Mr. ROSS. Yes.

Senator DASCHLE. I mean, you will be lucky to hit the nearest billion for 1990. But you have decimal figures here all the way out to 1999, and I just think for our own presentation it would just make better sense to be more realistic and accept the fact that you are not going to hit decimal projections.

Also, going to the chairman's first question. It was one that I had coming into this hearing, and I still do not understand your answer entirely. And it may just be that I missed it. You said that the reasons why the projections in your proposal now are substantially different from the projections you gave the committee in 1986 were basically twofold—first, the longer holding period and secondly, the are targeting.

That may mean a lot to the members that heard it the first time. But could you explain with a little more clarity how the holding period and targeting would so dramatically change your projections from what they were 2 years ago?

Mr. ROSS. Let me attempt to do that. There is another element of the explanation which is contained in my written statement which I did not provide for Senator Bentsen. I was trying to be more concise. The figure we gave at the time of Tax Reform was a $21.8 billion budget period revenue increase. A large part of that revenue pickup was simply the effect of taxpayers selling off assets at the end of 1986. That is behavior that would not have been reproduced.

Senator DASCHLE. That is right. I understand that.

Mr. ROSS. And that was in a sense a one time effect. In addition—and this point is more complex and it is dealt with in some length in my written testimony—we included in our estimate of the capital gain proposal a revenue effect that was really not attributable to the capital gain proposal. A large part of the revenue you pickup in eliminating a capital gain preference is, taxpayers no longer having an incentive to shift their portfolios in a way that generates capital gain rather than ordinary income.

And to the extent there is a differential between the rate at which we tax ordinary income and capital gain there is a greater or less incentive.

Senator DASCHLE. But how in the world do you quantify that incentive?

Mr. ROSS. Well, it is difficult to quantify it. But the point that I need to make is that, in 1986 we eliminated that differential, in a sense, from two directions. We took the rate of tax on capital gains from 20 percent up to 28 percent. At the same time we took the rate of tax on ordinary income from 50 percent down to 28 percent. If we had not affected—if we had not changed—the rate of tax on capital gains and just left it at 20 percent, we still would have picked up a lot of revenue from dropping the lower rate from 50 to 28 in this context, because taxpayers would have had only an 8.8

percentage point advantage in shifting ordinary income to capital gain. And as a consequence would have done it much less actively.

And there is, in that aspect of the rate reduction, a revenue pickup. Now that is independent of what you do with the capital gain rate. We, for a variety of reasons that really are a question of stacking order, attributed all of that revenue to the capital gain proposal when, in fact, only a piece of it was.

And the final part to the answer—I mean, that is a big part of the positive revenue pickup, which again is not directly attributable to capital gain. The final part of the answer, though, and it is a little unfair to you because this is probably where you wanted me to start, is that the proposal we are making now does not reverse in two important ways what was done in 1986. It narrows the pool of assets to get the preference. And the pool of assets that does not get the preference is a group that we think will not be sold in response to a lower tax rate. And thus by denying them the preference, you are avoiding a substantial tax loss that would occur from the lower rate and which is not offset in full or even in substantial part by increased realizations of that kind of asset.

I do not think I have done probably any better in providing you with a clear answer. I would be happy to spend some time with you after this.

Senator Daschle. Thank you, Mr. Chairman.

The Chairman. I hope the press followed that very carefully. [Laughter.]

Senator Durenberger.

Senator Durenberger. Thank you, Mr. Chairman.

Mr. Chairman, I have a statement that I would appreciate being made a part of the record.

The Chairman. Without objection.

Senator Durenberger. Mr. Ross, let me begin by expressing my appreciation as the last to have the opportunity to ask questions, for your responsiveness to everyone else's questions and to compliment my colleagues on the quality of their questions.

I would like to go back with a question or two where Jack Danforth left us on LBO's. As I recall the latter part of last year, the chairman of this committee finished running for Vice President of the United States, found out that he was still the chairman of this committee—much to his relief I am sure—and turned his attention to what seemed like two principle concerns facing this country. One was the panic in the savings and loan industry and the other was some degree of panic on leveraged buyouts.

I may be unique, but I do not sense that panic anymore, and I do not think—the panic dissipated—just because we had a series of hearings. I do not know what caused it.

What is your current sense and what is the administration's current sense relative to trying to change the balance between debt and equity financing. If there is some degree of urgency, would you argue that we need a tax bill, that we need to make more bold steps in the direction of reforming the inequity in the current tax code between savings investment on one hand and consumption on the other?

Mr. Ross. Well, the difficulty in making bold proposals, I suppose, is twofold. You obviously have revenue constraints. We are in a time when we cannot dedicate the tax revenue we might like; and other times to increase providing incentives for savings and investment—doing something about the problem of double taxation of equity. I think the other constraint in terms of bold action is trying to take account of what the market response would be.

Everyone has some sensitivity about how markets would respond to any substantial changes in the way we tax corporations and their financial structures. And we have, for that reason, espoused I think some sense of conservatism and caution in trying to think through what would be the appropriate long-term response there.

And again, in the near term, I think the capital gain proposal is at least a step in the right direction in terms of trying to mitigate to some extent the differential between debt and equity. You can argue it is not a bold or direct response to that problem—and I think that is probably a fair argument—but in the current climate I think it is a positive step forward. And until we have a firmer handle on, you know, what ought to be done for the long run, it seems to me a good place to start.

Senator DURENBERGER. I guess I asked the question knowing what the answer would be, like the answer to everything else we are doing this year, it is couched in "revenue" constraints. This implies that everything is going to go well as long as everything goes well. That seems to be where we are in 1989.

I have a different opinion, which is that if everyone knew where we were going to be 10 years from now, and that we were willing to do something bold this year to get there, that everything might go well this year, and next year, and the year after, and subsequent years. But I take it that small steps in the direction of a more bold tax policy is the current position of this administration.

Mr. ROSS. In this context, I think that is an accurate characterization.

Senator DURENBERGER. Some economists have indicated that they believe that a lower capital gains rate would encourage companies to engage in leveraged buyouts because there would be greater incentive to cash in capital gains as part of the transaction. What is your view on that, sir?

Mr. ROSS. Well, there are two effects I think of a change in the capital gain rate on LBO activity. By reducing the rate of tax on shareholders, which capital gain cut would do, you do reduce some of the tax cost of an acquisition. Shareholders pay less tax. In that sense the price that which they might be willing to sell is affected. Some of the tax wedge that might otherwise prevent a transaction from going forward is reduced.

I do not think it is fair though to say that you have encouraged leveraged buyouts. You may have, in a sense, made it easier for acquisitions to go forward. But you have decreased the advantage to those acquisitions of incorporating substantial leverage in the transaction because, again, you have narrowed the difference between debt and equity in a way that it significant. So, on balance, you might have given some encouragement to acquisitions but have decreased the extent to which they rely on leverage.

Both of those changes, by the way, move in the direction of a more neutral tax system. Since the——

Senator DURENBERGER. Let me ask my last question.

Mr. Ross. Sure.

Senator **Durenberger**. On the short-term/long-term—and obviously most of us here I think favor moving our investments towards the direction of long-term. I thought in the bill I introduced last year that we might accomplish that by providing like a 40-percent exclusion for assets held 4 years; 60 percent, 6 years; 80 percent, 8 years, and so forth.

What is your view on that?

Mr. Ross. That is a possible approach and one we gave some thought to. Again, it would have the effect of encouraging long-term investment. It is a more of, I suppose, refined and concentrated way of doing that, saying the longer you hold it, the better. This is a simpler cut at it, saying beyond three years is long enough and we think deserves a preference; short of three years, you do not get anything. I mean, I think that is an alternative that merits some consideration. I do not think conceptually it is a lot different than what we are trying to do here.

The **Chairman**. Thank you.

Gentlemen, we have a number of interesting witnesses yet to be heard. And unless you feel strongly and cannot defer your question to the next witness, I would ask you to pass if you will.

Mr. Ross, I understand your tenure is coming to an end. Is that correct?

Mr. Ross. It is rapidly, Mr. Chairman, yes.

The **Chairman**. Friday?

Mr. Ross. Actually, Monday.

The **Chairman**. Monday?

Well, let me state that you have been an articulate witness in the administration's behalf. You have done a good job this morning and we appreciate your public service.

Thank you very much.

Mr. Ross. Mr. Chairman, it has been a great privilege to appear before this committee in a number of contexts and I am greatly appreciative for having that privilege.

Senator **Bradley**. Mr. Chairman, could I just echo your words. Because I think frequently we pay our respects to the Secretary and to the number one or two. But we know how long you have been there and how much work you have done and it has really been excellent.

Mr. Ross. Thank you, Senator.

The **Chairman**. Thank you.

I see Senator Boschwitz is here.

Senator, we have put a limitation on everyone at 5 minutes. If you would come up and make your presentation, we will take your entire statement for the record. Then we will get to such questions as we might have.

STATEMENT OF HON. RUDY BOSCHWITZ, A U.S. SENATOR FROM MINNESOTA

Senator **Boschwitz**. I thank you, Mr. Chairman. I have my statement. It is going to be difficult to stay within five minutes but I will try to do so.

I have long been a proponent of giving enhanced treatment to capital gains. Although I supported the 1986 Tax Bill, because I felt it was a fair trade, I did nevertheless try unsuccessfully to retain the capital gains treatment. I have introduced legislation that allows capital gain to have a 40-percent exclusion for holdings of 1 year and a 60-percent exclusion for holdings over 3 years. It is kind of a two-tiered approach.

In the last Congress, Senator Evans added to my approach another bill allowing a 100-percent exclusion where the assets have been held 5 years. I will not review these ideas further, as my testimony goes into the comparison between our treatment of capital gains and the capital gain treatment in other nations. Suffice it to say that we do create some disincentives through our treatment of capital gains.

I want to inform the committee that have put together the Capital Gains Caucus and we now have 16 members. I presume that membership will increase as the debate strengthens.

I wanted to specifically comment this morning, Mr. Chairman, about Senator Armstrong's bill of which I am very supportive. And that is, to use the present rates of tax but do not tax the inflation part of the gain.

The CHAIRMAN. Do not what? I did not understand that. Do not what?

Senator BOSCHWITZ. Do not tax the inflation part of the gain.

The CHAIRMAN. All right.

Senator BOSCHWITZ. In other words, allow the basis for tax computation purposes to rise with inflation.

I spoke to somebody yesterday, as a matter of fact, who had been in the same business for 40 years. He has been in the same building for that whole period and he has it depreciated down. It is a furniture store. If he turns around and sells it now he is going to be among the rich in the year that he sells it. But in the next year, he will return to a more normal status.

However, in calculating what percentage of capital gains inures to people with incomes over $100,000, he would probably be in that class because of that building or because of that capital asset in a single year.

A farmer would be, too. If a farmer works the land for many years and then makes a sale in one particular year, he joins the rich at least for calculations of that particular year.

So I am most, most supportive of capital gains reform. It is for that reason that I appear before the committee today. I am most supportive of the idea that there should not be a tax on the inflation elements of the gain. I am most supportive of the idea that the basis should rise with inflation. Of course, the basis would be reduced by depreciation, if it is a depreciable asset but that otherwise the basis of asset—be it stock or be it real property—would rise with inflation.

That, in my judgment, is a fair way to tax capital gains and also gives an incentive to hold on to investments, which I think we want to do.

Mr. Chairman, that concludes my statement. I would ask that the entirety of my statement be included in the record.

The CHAIRMAN. That will be done.

[The prepared statement of Senator Boschwitz appears in the appendix.]

The **Chairman**. I have no questions.

Senator Packwood.

Senator **Packwood**. No questions, Mr. Chairman.

The **Chairman**. Are there other questions?

Senator **Durenberger**. Mr. Chairman, just briefly, let me compliment my colleague. First, for the obvious, he kept his statement within 5 minutes. And as you anticipated in your comments, we did not expect that. But I think it is because, even before he came to the U.S. Senate, Rudy has been educating a lot of people on the value of savings and investment. He demonstrated the value of it himself in his own business and particularly I appreciate the contributions that he has made in the past and the contributions he is going to be able to make to us on this committee as we deal with the capital gains issues.

Senator **Boschwitz**. I thank you, Senator. I really feel that incentives to invest are an important element of economic growth. And since the incentives are probably not going to come through the lowering of capital gains rates, that the most equitable approach would be to allow the basis of the asset to rise with inflation so that the gain that is only associated with inflation would not be subject to tax.

I think that that is a special aspect of a capital that causes it to different from, for instance, earned income in general, where inflation does not play a part.

I thank you, Mr. Chairman; and I thank the other members of the committee.

The **Chairman**. It is good to have you Senator.

Senator **Boschwitz**. Thank you.

The **Chairman**. We will take your full statement. Thank you.

Our next witness is Mr. Pearlman, who is chief of staff of the Joint Committee on Taxation.

Mr. Pearlman, you have some associates of yours, if you would introduce them for the record, please.

STATEMENT OF MR. RONALD A. PEARLMAN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION ACCOMPANIED BY MR. THOMAS BARTHOLD, ECONOMIST, JOINT COMMITTEE ON TAXATION, AND MR. RANDALL WEISS, DEPUTY CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mr. **Pearlman**. Thank you, Mr. Chairman.

With me at the table this morning is Randall Weiss, Deputy Chief of Staff of the Joint Committee and Thomas Barthold, an economist and a member of the staff. I might note to the committee that this will be Randy's last appearance before the Finance Committee after a number of years of service on the Joint Committee's staff. I can tell you on behalf of the Joint Committee staff we are really going to miss him.

I am very pleased to have the opportunity to appear before you today to discuss what is, obviously, an important subject. We will submit our entire statement for the record.

Yesterday we released a hearing pamphlet that seems to deal not only with the historical kinds of information that might be helpful to you but some of the important policy issues involving capital gains. I will not take time this morning, because they are dealt with in the pamphlet, to go into those; but I would encourage you in your deliberation on this issue, your inquiries with other witnesses, to address some of these important policy issues. They are certainly as important as the revenue analysis.

I would note the savings and capital formation issues and the extent to which we can really get a handle on whether there is a link between capital gains and savings and capital formation and complexity, which we do not see talked about very much in connection with a capital gains rate, but which is a very important issue in considering the return to a preferential rate.

What I want to do now is turn to our capital gains revenue estimate. As you know, from the discussion that you have already had this morning with Mr. Ross, the revenue estimate for capital gains is heavily influenced by our analysis of taxpayers' behavioral response to the proposed rate change. Now we make that analysis of taxpayer response essentially as a judgment call. We look at the empirical and theoretical work that have been done by research economists and others. And perhaps most importantly, to the extent that history gives us some guidance as to taxpayer behavior, as we believe it does significantly in connection with capital gains, we rely heavily on it.

The decision to sell a capital asset and to realize a gain or a loss is largely a discretionary decision on the part of an investor. In fact, we know very little about why investors choose to buy and sell assets. We do know, that taxes are only one of many factors that enter into their decisionmaking process.

Table 1 appended to our testimony, our statement, contains our estimate of the administration's capital gains proposal. Summarized briefly for the first couple of years, it shows a revenue increase; for the 5-year budget period, it shows an overall revenue decrease of $24 billion; and then we have extended the normal traditional 5-year budget window into a 10-year window in order to permit comparison with the Treasury information. During that period we estimate a reduction in Federal receipts of some $67 billion.

Now, as you can see from that table 1—lines 1 and 2—our estimate of providing a 45-percent exclusion assumes substantial behavioral reaction in the short term. That is, the taxpayers will respond to this lower rate by selling existing assets and it will be so substantial in the short term that over the first couple of years the revenues for increased realizations will be sufficient to offset the revenue loss from a static reduction in the capital gains rate.

We believe this so-called unlocking effect, however, is a temporary phenomenon and that after an adjustment period, taxpayers will settle into a lower, more permanent level of realizations. This is not to say the level will be the same as prior to a rate reduction. To the contrary, our revenue estimate assumes that individuals will realize more than $600 billion in capital gains during the budget period in excess of what they would have sold at the higher rate, or to put it another way, that that would offset about 70 percent of the static revenue loss.

The administration's proposal reduces the tax rate on capital gains by approximately 50 percent—about 47 percent to be exact. As a result, if Federal revenues are to remain unchanged or indeed are to be positive on the long term, realizations essentially must double. If a permanent revenue gain is predicted, then realizations must more than double. In our judgment, we do not think the historical record supports that result and I would refer you to table 2 of our statement—and particularly column 2, which seeks to show realizations or sale increases year to year—and have you just eyeball that and see if, on the basis of that review, you believe a projected doubling or more than doubling of realizations accords with history.

We arrived at our estimate after considering many academic and government studies which have attempted to analyze taxpayer response. In these studies, economists characterize taxpayer behavior in terms of what they call elasticity. This is merely a convenient mathematical way to measure taxpayer responsiveness. The studies have adopted several different mechanisms for analyzing elasticity.

Our statement, beginning on page 16, goes into that. I am not going to go into that here, except to say that as best we can conclude, we cannot conclude that realizations are all going to be explained by a tax response. For example, they will be explained in part by GNP growth and in part by the performance of the stock market.

Our estimate of the administration's proposal used a short run elasticity of 1.2—that is an elasticity which would show a revenue increase; and a long run elasticity of 0.71, which would indicate a revenue loss. Because the administration proposes a reduction in the tax rate of approximately 50 percent, as a I mentioned, we would have to estimate that the administration's proposal would be a revenue raiser by concluding that realizations would more than double and that the doubling would have to occur after one has already accounted for growth of the economy on future gain realizations.

In the 7-year period between 1981 and 1987, taxpayers realized a total of approximately $1 trillion of capital gains. This 7-year period followed the 1978 capital gains rate reduction, the 1981 capital gains rate reduction and includes probably the strongest bull market in the Nation's history. It also includes the tremendous temporary unlocking which occurred in 1986.

For the administration's proposal to generate permanent revenue increases in the 5-year window from 1991 to 1995, taxpayers would have to realize more than $2 trillion in gains. We simply do not believe that history supports that.

Capital gains estimates are difficult. The discussion this morning has already indicated that and I am sure the subsequent aspects of this hearing will indicate that. Every estimate is subject to uncertainty. In spite of that uncertainty, we, as the Treasury, have a job to do and that is to provide the Congress with the most informed and reasoned estimate of the revenue impact of a proposed tax law change as we can.

That is not to say that our estimate is correct. After all, it is just an estimate. But I do believe the analysis we have employed is in accord with the historical data we have before us. We believe a rate change will result in a significant short run behavioral affect and more modest permanent behavioral effects.

This is an analysis which is consistent with the realizations following the rate reductions of 1978 and 1981. It is an analysis which is inconsistent with a prediction of permanently doubled realizations. It is in our judgment the most reliable analysis for use today.

We will be happy to try to answer your questions.

[The prepared statement of Mr. Pearlman appears in the appendix.]

The CHAIRMAN. Mr. Pearlman, what effect do you think the administration's proposal would have on the length of time that a stockholder would hold stock?

Mr. PEARLMAN. Mr. Chairman, I think it will have two effects. On the short term, there should be some encouragement to holding stock by taxable taxpayers a bit longer. Now, as I know you know, a large portion of the equity in this country is owned by tax-exempts and, obviously, would have no effect on them.

There is an interesting other side to that, though, and that is the long term. To the extent that either we, or Treasury, or others predict an unlocking, then those equities that are unlocked in effect become shorter term. So that, for example, if we assume that a portfolio is owned for ten years or until death—you know, an overall portfolio—that there is an attraction to holding it longer, that it is locked, an incentive to unlocking shortens that holding period.

Now that may maybe not be viewed as bad, but there are two sides and it depends what side of the 3-year holding period you look at. On one side it seems to me it is positive in lengthening the holding period; on the other side, it is likely to shorten the holding period.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Ron, what is the difference between the so-called time-series analysis and the cross-section analysis that you and Treasury seem to use differently?

Mr. PEARLMAN. Senator, with your indulgence, I am going to let one of the economists respond to you on that.

Senator PACKWOOD. Okay.

Mr. PEARLMAN. Tom.

Mr. BARTHOLD. Senator Packwood, the basic difference between a cross-section and time-series analysis is a cross-section analysis will look at a large number of taxpayers and what kind of tax rates they have and what sort of capital gains they realize all within 1 year. Whereas, a time-series analysis——

Senator PACKWOOD. You mean horizontally across all the taxpayers?

Mr. BARTHOLD. It is cut horizontal across the taxpayers.

The time-series analysis, on the other hand, you could think of in a vertical sense. It typically looks at aggregate taxpayer data, such as aggregate realizations and some sort of average marginal tax rate, and looks at that through time. So that we see the response through time on a time-series analysis holding constant individual effects and in a cross-section analysis you have held constant time but you have lots of individual specific data that you can look at.

Senator **Packwood**. And for whatever reasons, you prefer the latter and Treasury uses the former?

Mr. **Barthold**. Well, I think we have some good reasons and that there are some good reasons in the economic literature for our choice. Without going into detail, I would like to suggest that when you look at a cross-section study, it is sometimes not clear exactly what the study is measuring. For example, you might have a taxpayer who we would calculate to have a low marginal tax rate in a particular year and that might have been because he had successful in arranging his affairs, perhaps, through tax sheltering to have a low marginal tax rate in that year. If he has a low marginal tax rate in that year because of tax sheltering, it would pay for him to realize gains. Now that does not mean that if he permanently had a low tax rate, year in/year out, that he would continue to realize gains at the same pace that we see in that one particular year.

Senator **Packwood**. Well then the cross-section analysis is very dependent on the year you pick?

Mr. **Barthold**. Well, I think an additional failing to cross-section studies is, that they cannot account for changes that happen through time. As Ron Pearlman suggested, we also believe that important factors are GNP growth and the role of the stock market in terms of talking about gain potential. And there is no way you can see any variation in the data in those sort of macro-economic variables when you look at one year. So, your comment is correct.

Senator **Packwood**. Let me ask you, or anybody who wants to answer it, Ron, assuming that you were to consider the President's proposal, in your judgment, what is the merits of limiting the proposal to just corporate stock and a select few other assets?

Mr. **Pearlman**. Well, I think we understand what the administration is driving at and I think it is fair to articulate it as saying that they believe that corporate equity represents most of the productive business of the country; and, therefore, by seeking to target the incentive to corporate equity and excluding other assets, that you get more bang for the buck, if you will.

I think the concern, frankly, that we have and that we have expressed—I mean, it is a technical type concern, but I think it is a serious one. In fact, it came up in the discussion early, is when you draw that kind of distinction, what does it mean for assets that fall outside of corporate classification? For example, if—and I will use your question this morning—timber is outside the corporate forum, it gets one result; if it is inside the corporate forum, it gets another. That, to me, is a troubling distinction in terms of designing a tax provision.

In other words, if the Congress were to adopt the administration's proposal, how do we design a rule that does not force people to respond to the corporate incentive we give them. But I think it is fair to say, it was simply a narrowing proposal directed at assets which the administration believes are the most productive in the economy.

Senator **Packwood**. But it would also be limited to those that they thought might be the most productive in terms of revenue?

Mr. **Pearlman**. Well, I would presume that, if you look at the revenue table they would agree. I am somewhat reluctant with my present hat on to be talking about what the administration would think. But it appears that the consequence is one of saving revenue in this proposal. But I have to say in fairness that when I was at the Treasury Department and we tried to put together a capital gains proposal as part of the tax reform aimed at productive assets, one of the things we looked at was a proposal that was limited just to corporations and it was not driven by revenue, it was driven by the notion of you wanted to target the benefit.

We concluded that we could not do it because we could not stop people from moving assets in and out of the corporate form without an elaborate set of rules that probably would have been maybe inadministerable.

Senator **Packwood**. In your judgment, what is your opinion about the President's proposal to not treat any capital gains differential we may restore as a preference for the minimum tax?

Mr. **Pearlman**. I am trying to comment without being critical and trying to be objective. I mean, the theory of the minimum tax, you know—as you can articulate having been through the 1986 Act better than I—I think, is one in which we wanted to make sure—the Congress wanted to make sure—that every individual that had economic income paid at least some level of tax.

To the extent that anything is taken out of the minimum tax, obviously, that theory is affected. Now, to the extent that one believes that there is an appropriate reduction of tax on capital income and that it should not be subject to tax, as some would argue to you, perhaps that exception is appropriate. But clearly, it would appear inconsistent at least with the decision the Congress made in 1986.

Senator **Packwood**. Thank you, Mr. Chairman.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Ron, I think that your testimony has really been extremely productive.

But before I talk about that, I just want to pay tribute to Randy Weiss, publicly, for the outstanding work that he has provided to the whole committee. I think the whole Senate will miss him and I think he deserves all of our commendation.

In your testimony, you have a very interesting formulation. You say that in order to offset the loss in revenue from the cut in the capital gains rate, that the amount of capital gains realization has to basically double. That was the formulation. That is a very clear formulation. That the transaction value of all capital gains has to double, basically. You also—and what was the cut in capital gains in 1978, was from what?

Mr. **Pearlman**. Well, the 1978 one is a difficult one. It depends on what you view as the maximum rate. If you include the alternative minimum tax, I think the reduction was some 43 percent; and if you exclude the minimum tax, I think it would be——

Senator **Bradley**. But it was from what to what?

Mr. **Pearlman**. Oh, I am sorry.

Well, the regular rate in 1978 was 70 percent; then there was a 50-percent exclusion—creating a 35-percent rate. They moved to a 60-percent exclusion which took you down to a 28-percent rate.

Senator BRADLEY. Okay.

Mr. PEARLMAN. But there was an alternative minimum tax. So one could say, you were moving from a 49-percent effective rate to 28.

Senator BRADLEY. Right.

Mr. PEARLMAN. But it is somewhere in that range.

Senator BRADLEY. So it went effectively from 49 to 28 percent. And then you had the 1981 act that moved it effectively from 28 percent to 20 percent. So that in the period that you analyzed, 1981 to 1987, we essentially cut the vote from about 49 to 20 percent. In addition to that, taking the other factors into consideration, this was the period of one of the biggest stock market booms in recent memory, that goes up to the crash, basically.

In addition to that, you have the unlocking effect of the 1986 act. The base line estimate was that if you did not change the 1986 act, you would end up with what the number is here, about $152 billion in capital gains when the actual capital gains was about $300 billion. Right?

Mr. PEARLMAN. Yes, slightly over $300 billion.

Senator BRADLEY. $320 billion. So that taking into consideration the drop in the rate, the booming stock market, and the $320 billion realization due to the lock-in, you end up with a total capital gains realization in that period of $1 trillion. And you are saying to offset this cut in rate, that there has got to be a realization of $2 trillion in order for there to be a revenue gain as opposed to a revenue loss.

I think those numbers on their face just make it crystal clear that the revenue gain is, I say, more than highly unlikely, or improbable. But it is almost certain that you are not going to have a revenue gain. I think that your testimony here today gives us a very good frame of reference to look at these questions.

Mr. PEARLMAN. Senator, we could spend time getting into the details of your analysis and there are a few things I think in fairness probably are appropriate to quibble about. I think the important thing is that we rely heavily on the historical data; and there is clearly disagreement among economists as to what the behavioral response will be. I am not suggesting, and I do not think the committee should consider, our conclusion as necessarily better than anyone else's. But we believe that putting the historical data in front of you is the most reliable thing we could do to permit you to make your conclusion as distinguished from us making it for you.

Senator BRADLEY. And one last point. At least the burden of proof then rests on the proponents of the cut to show how this will produce a $2 trillion capital gain realization, basically. I would say that is fair.

Now, what percent of capital gains are taken by tax-exempt entities—endowments?

Mr. PEARLMAN. I am not sure any of us can answer that. I think the current estimate is that tax-exempts and foreign investors own something over 35 percent of the corporate equity.

Senator BRADLEY. Right. So that for 35 percent to the owners of—not necessarily those who take capital gains—but to 35 to 40 percent of those people who own equity, this provision does not affect them at all, right?

Mr. PEARLMAN. I think that is correct.

Senator BRADLEY. It does not affect them at all.

Mr. PEARLMAN. That is correct.

Senator BRADLEY. Because if you are tax-exempt, you are tax-exempt. You do not have more incentive if the rate drops. So I think that both of those considerations will be important for the committee; and I thank you for your testimony.

Mr. PEARLMAN. Thank you.

The CHAIRMAN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman.

Well, Ron, in view of the fact, my view is that, if you have a capital gains differential—a capital gains tax that is lower than the income tax—at least you reduce the part of people's income that the government benefits from just by having inflation on fixed assets. Do you agree with that?

Mr. PEARLMAN. Clearly, any reduction in tax rates, Senator, is going to reduce the tax burden on that income, yes.

Senator SYMMS. Based on the model we have developed, what would be the short run and the long run effects on indexing of this model, just prospectively—you know, not looking back at the past—if we lowered the capital gains tax rate to 15 percent?

Mr. PEARLMAN. Well, I want to make sure——

Senator SYMMS. Let us say you do not tax inflationary gains, is what I am talking about.

Mr. PEARLMAN. I am not sure I fully understand your question. But if when you asked what the effects are, you mean—let me guess and then you tell me if I am not understanding you correctly—if we introduced an indexing system—let us assume we leave the rate as it is today—what would be the taxpayer response to that. I think—I am happy to be corrected by one of my colleages—that that also would have a relief of the unlocking phenomenon.

That is, lock-in results from the fact of inflation. If the tax rate today is 28 percent and you sell today, you know it is going to be 28 percent; if you wait five years to sell, it is going to be 28 percent but you have had all those inflationary gains, then you might conclude not to sell. To the extent you adjust the basis of the asset so that your current rate does not hit those inflationary gains——

Senator SYMMS. Right. That is what I am talking about.

Mr. PEARLMAN [continuing]. It takes pressure off of the disinclination to sell down the road. So I think that an adjustment to an indexing system with all of its problems would take pressure off of the notion of lock-in.

Senator SYMMS. It has been observed several times today that the stock market boom accounted for a substantial part of the increase in revenue from capital gains taxes during the time of the 20-percent rate. Now, are those two things unrelated or can we assume, at least in part, that the rate cut helped in the boom?

Mr. PEARLMAN. To me, that is sort of the bottom line question, Senator. I mean, it seems to me that when you look at the whole capital formation savings issue you have asked the right question.

The problem is, you have asked it to the wrong person because I do not know. I mean, the simple fact is, I do not know.

What we suggest to you is, that what we are able to do—that is, review of the economic literature suggests that the link is not clear to us. But I would strongly encourage you, during the remainder of this hearing, when you are going to have some very knowledgeable witnesses who can comment on that—and in the process of deliberating this issue—that you pursue that question.

Because it would seem to me that the committee would want to find the link because everyone is in favor of, you know, capital formation and savings. The key is, is there a link? As I said, it is not apparent to us.

Senator SYMMS. Thank you very much, Mr. Chairman. Mr. Chairman, I am afraid I may not be here during all the time of the next witnesses, but I hope they will address that question and I will read the record.

The CHAIRMAN. Fine.

Thank you very much, Mr. Pearlman.

Let me say again—echo what was said about Randy Weiss. You have been a fine public servant. You have been a major contributor to our deliberations and we wish you well in your endeavors.

Mr. WEISS. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. PEARLMAN. Thank you.

The CHAIRMAN. And now this group of experts that can answer all those questions is coming up.

Dr. Auerbach—if you would come forward—Dr. Roberts, Mr. McIntyre, and Dr. Walker.

If you gentlemen would limit your presentations to 5 minutes, then we will get to the questions.

Dr. Auerbach, if you would lead off, please.

Dr. AUERBACH. Yes, sir.

STATEMENT OF DR. ALAN J. AUERBACH, PROFESSOR AND CHAIRMAN, DEPARTMENT OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA

Dr. AUERBACH. I will just try to give you a brief summary of the points; and I will, of course, be happy to answer any questions afterward.

Let me summarize the conclusions that I come to in my testimony. First of all, as you can probably surmise from what has already been said today, there exists no convincing empirical evidence that a reduction in the tax rate on long-term capital gains of the type proposed by the Bush administration would raise tax revenue in the long run. And because of volatility of capital gains realization behavior, any short run revenue estimates are subject to considerable error.

The historical data that Ron Pearlman just presented along with some representative calculations that I present in my testimony, suggest that in the long run a positive revenue impact seems very unlikely.

However, I also stress in my testimony my belief that the revenue effects of this particular type of capital gains tax proposal, or any similar capital gains tax proposal, have been overemphasized in the policy discussion. After all, there are many very worthwhile tax proposals that might lose a little bit of revenue and still be worth undertaking and there might be other, fairly silly, tax proposals that would gain revenue that would not be worth undertaking.

Revenue is surely not the only consideration that ought to be of concern to the committee. I am sure it is not. But the impression that one gets, certainly, from the popular discussions of the capital gains proposal is that revenue is the only concern. If this were a fundamentally sound proposal and the right proposal to meet the goals that the administration and other proponents of capital gains tax reductions sought, then it might be worth undertaking.

Therefore, the second part of my testimony goes into these questions and asks what it is that is sought by a reduction in capital gains tax rates; and is the reduction in capital gains tax rates the appropriate or the best solution to that particular problem.

The conclusions that I reach in my testimony are that, in general, the major problems that people usually consider when advocating capital gains tax reductions would be better solved by alternative mechanisms. A couple of them have already been mentioned this morning. For example, with respect to the inflation problem, indexing has been proposed. It is certainly no stranger to this committee. It is the correct solution to the problem of the inflation component of capital gains being taxed. To advocate a reduction in capital gains tax rates because of the inflation problem is to ignore the very clear alternative and superior proposal that could be undertaken.

Second, venture capital—and this has also been mentioned by Senator Bumpers in his testimony. Some of the comments in my testimony are consistent with some of the points that he made, having to do, for example, with trying to focus a reduction in capital gains tax rate, much more on smaller enterprises—riskier enterprises—and in particular, enterprises where the capital gains on stock are associated with initial ventures rather than somebody just holding shares in the company.

Some proposal like that would surely make more sense than an across-the-board cut in capital gains tax rates, even if it were only focused to common stock. The fraction of common stock represented by the holdings by taxable investors of venture capital type operations is minuscule. The Treasury's 1985 report detailed that quite clearly.

Therefore, I continue to be surprised that proposals to reduce the overall rate of tax on capital gains are defended on the grounds of spurring venture capital. It is surely not the most cost effective way of doing it.

Finally, on the issue of corporate planning horizons, the point made already deserves stress, that extending the holding period to 3 years may have the effect of inducing people to hold stock for a longer period. But on the other hand, the fact that the rate is reduced after a 3-year period encourages people to sell. It is not clear to me that the net effect of the 3-year holding period, plus the reduction after 3 years, will lead to an overall increase rather than a decrease in the holding period of common stock.

Finally, let me make one more point on the issue of venture capital. It has been said that cutting capital gains tax rates overall may encourage venture capital—more money to be given to venture capital. But to the extent that it encourages the retention of earnings by existing corporations to deliver more of their return to investors in the form of lightly taxed capital gains, it may actually be counterproductive.

By having preexisting companies retain more of their earnings, rather than have those earnings flowing back into the capital market, it may actually serve to starve those companies that are seeking new funds in the capital market—presumably the kinds of companies that Senator Bumpers was concerned with in his discussion this morning—that would find it more difficult to raise money in the new equity market because that money would be remaining inside existing companies.

Therefore, the idea of encouraging this sort of venture capital formation by an across-the-board cut in capital gains taxes might actually be counterproductive.

Thank you.

The CHAIRMAN. We will listen to each of you and then get to the questions.

[The prepared statement of Dr. Auerbach appears in the appendix.]

The CHAIRMAN. Dr. Roberts.

STATEMENT OF DR. PAUL CRAIG ROBERTS, WILLIAM E. SIMON CHAIR IN POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

Dr. ROBERTS. Thank you, Mr. Chairman.

Here in our country, Mr. Chairman, we have managed to put together a tax system that is biased against the accumulation of capital. We have apparently done this partly out of ignorance and partly out of envy, one of the original seven deadly sins, believing that the benefits of capital flow primarily to the rich. All sorts of shoddy statistics have been used to created perpetuate this self-mutilating illusion. So we seem to be doomed to forever cut off our nose to spite our face.

As a result, we have a tax system that is heavily biased and unfair in its treatment of saving and investment. Investment is subject to multiple taxation which reduces the rate of return to the owners of the investments far below the value of their investments to society. Consequently, we have less investment than is socially desirable.

My research has shown that taxation is a more important element in the cost of capital than the interest rate. Over the past 4 or 5 years, I have shared my research results with this committee and I have published them in scholarly publications. Sooner or later everyone is going to acknowledge the impact of taxation on the cost of capital.

Like other taxes, the capital gains tax raises the cost of capital. There is something to be gained from lowering it, as long as we do not feel we have to get it back from the rich by raising some other tax, such as the personal income tax rate.

An excellent case can be made for abolishing the capital gains tax altogether. It is not a tax on income. The national income accounts do not recognize capital gains as income nor do they include them in the measurement of GNP. The capital gains tax is a wealth tax. Furthermore, it is one that was brought in dishonestly through the back door.

The tax on capital gains is a tax on the rise in the price of an asset, reflecting either inflation or the stock market's estimate that a company's future earnings will be higher. If the price of the asset rises because of inflation, there is no real gain at all and the tax is nothing but a confiscation device. If the price rises because the company's earnings improve, then these earnings will be subject to double taxation—first as company income and then as dividend income to individuals. Taxing the capital gain simply taxes the same income a third time.

Now, if envy prevents the capital gains tax from being cut, it could at least be indexed for inflation. That way, only real gains would be subject to tax and this would introduce a small element of fairness into an unfair tax. However, indexing the capital gains tax rate, or reducing the capital gains tax rate, will do little in itself to redress the extraordinary tax bias in our tax system against saving and investment. That would take a true tax reform, something along the lines of the cashflow tax or the consumption-based income tax that the Treasury proposed in "Blueprints for Basic Tax Reform" more than a decade ago in January 1977.

The 1986 bill was a psychological victory in getting the tax rate paid by free Americans down to the maximum level that robber barons could extract from medieval serfs. However, from the standpoint of the real unfairness in our tax system, the multiple taxation of saving, it was largely a pointless exercise.

Therefore, I see no problem in opening up the 1986 bill if Congress will use the opportunity to construct a tax system that fosters growth and success in place of one that panders to envy.

I will turn back in the rest of my time, Mr. Chairman.

The CHAIRMAN. Mr. McIntyre is director of Citizens for Tax Justice.

[The prepared statement of Mr. Roberts appears in the appendix.]

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. MCINTYRE. Thank you, Mr. Chairman. I see the setup today is Mutt, Jeff, Mutt, Jeff—and that may make for an interesting discussion.

You know, it is only three years ago that this committee voted unanimously to eliminate the capital gains differential. It was an essential part of the Tax Reform Act. Without it, or if gains had been indexed, you would have needed at least a 40-percent top tax rate to have been fiscally and distributionally neutral. That is why Senator Packwood led the way to getting rid of this longstanding tax break. Because people understood that capital gains are concentrated among wealthy people and, therefore, that keeping the tax break would mean a very large tax cut for wealthy people. I do not think anyone argues that part of the issue.

We have a chart on page 2 of our testimony that illustrates the static effects of the Bush plan on people's taxes. As you can see, the richest 1 percent would get a tax cut of about $25,000; the bottom 80 percent would get a tax cut of about $15 or $20. In fact, two-thirds of the benefits would go to the top seven-tenths of 1 percent of the population.

Now, the Bush administration has an argument why we ought to do this anyway, why we ought to undermine reform and go back in the direction of the old tax system. The administration says that we will get more savings, more venture capital and, indeed, more revenue if the capital gains tax is cut. Well, let us look at those arguments. They have been made before. It is very familiar litany to this committee, I am sure.

Capital gains taxes, as you know, were cut back in 1978 and 1981. That was followed by a drop in the savings rate to the lowest level in post-war history, suggesting that perhaps capital gains tax cuts are not a boon for savings.

In terms of venture capital, the pension funds certainly started to put a lot more money into venture capital around the time that capital gains taxes were cut, because the ERISA rules were changed. But, of course, pensions do not pay taxes. The share of venture capital money coming from individual investors went down after capital gains taxes were cut.

And since capital gains taxes were raised in 1986, by the way, the venture capital industry is doing great. There was a story in the Post a few weeks ago which quoted some of the venture capital people out in California as saying, well, yeah, it did not have much effect since most of our investors are tax-exempt. That is something important to keep in mind.

And finally, revenues. As you heard before today, the Bush administration in its wisdom suggests that capital gains realizations will double if the tax rate is cut in half. On page 5 of our testimony, we have some figures showing what those numbers would have to look like. You have heard them from the Joint Tax Committee as well. Realizations would have to go roughly from $1 trillion in projected gains to $2 trillion—something that is just unprecedented.

Now, if you look at the historical record and you see what happened to capital gains and why they went up in the 1980's, you see several things happening. One, the stock market went up. Of course, the stock market went up after capital gains taxes were increased in 1986 and so did capital gains tax revenues. So you cannot really give the capital gains tax cuts credit for helping the market, unless doing anything at all to capital gains helps the market.

Also, we saw a big boom in tax shelters during the 1980's. A lot of those were designed to generate capital gains out the other end. In 1985 there were $85 billion in tax shelter losses reported; in 1986, almost $100 billion. A lot of those were planned to come out as capital gains—out the other end. And finally, you saw the big wave of mergers and acquisitions—$600 billion in stock retired. A lot of that went to individual investors and showed up as capital gains. It is hard to figure the tax rate had anything to do with these involuntary sales.

Finally, you might want to look to the north, and learn a lesson from Canada. A Canadian economist, a few years ago, was wondering if his country had missed the boat by not cutting capital gains taxes in the late 1970's, because he had read all of these so-called studies showing that our tax revenues might have gone up. He checked. He found out that in Canada, where there had been no change in capital gains taxes, people cashed in more gains just like they did in America. Why? Because the stock market went up, not because of a lower tax rate which did not even happen in Canada.

The difference between us and our neighbors to the north was that they collected more tax revenues. We did not.

People talk here today, and they should be talking, about competitiveness and trade and international balances. That is a very important issue. This capital gains proposal strikes to the heart of it. If we cut capital gains taxes and lose even more revenues from the Treasury, then we are going to have to borrow more. When we borrow more, it is going to be largely from foreign investors. When they lend us the money, they will not be able to buy our goods and our trade deficit will increase.

So, if we want to do something about trade, it is time to get serious about addressing the deficit and raising taxes on those who can afford to pay, not to give another round of tax cuts to the wealthy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McIntyre appears in the appendix.]

The CHAIRMAN. Dr. Walker.

STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC

Dr. WALKER. Thank you very much, Mr. Chairman.

Mr. Chairman, it seems to me that the question before your committee is of great importance and can be simply viewed in one way. Namely, is this committee prepared to take the first important step in reversing a 7-year tax policy which has impaired this Nation's future international competitiveness by sharply increasing the capital costs of investing in productive equipment?

Make no mistake about it, a high, sustained rate of investment in modern, state-of-the-art machinery and equipment is essential to U.S. competitiveness. It is the only way our high-wage economy can restore the productivity growth that allows us to compete with low-wage industrial nations around the world.

Mr. Chairman, tax legislation in 1978 and 1981—and you were a key leader in the debate leading to passage of those measures—sharply reduced the U.S. tax hit on individual and business saving and investment. It did this by slashing taxes on capital gains; reducing taxes on individual saving, through liberalization of IRA's, and on gifts and estates; and creating the best capital-cost recovery system in the industrial world.

Federal taxation of business saving invested in producers' durable equipment was in effect set at a level which approximated the expensing of such investment, an approach which is similar to a consumption tax regime and which sharply reduces the multiple taxation of saving at the corporate level. In essence, the 1978 and 1981 legislation provided a much more level playing field for business decisions to save and invest versus paying out earnings as dividends.

Unfortunately, 1981 was the high-water mark of our efforts to at least reduce the heavy hit of an income tax system on productive capital formation. As the Federal deficit emerged and its reduction gained the central focus role of fiscal policy, Congress moved to raise business taxes sharply and to dismantle most of the pro-capital-formation measures adopted in 1978 and 1981.

These steps started with the Tax Equity and Fiscal Responsibility Act of 1982 and culminated in the Tax Reform Act of 1986. As a result, the capital costs of investing in equipment soared between 1981 and 1986, rising, according to the Congressional Research Service, by a whopping 90 percent for manufacturing, 98 percent in oil and gas activity, and more than 100 percent for construction. These increases have contributed to overall capital costs in this country that experts estimate are 50 to 75 percent higher than in Japan and also higher than those in other industrial nations abroad.

Such high capital costs are bound, sooner or later, to slow our already lagging investment per worker, to further slow productivity growth and to hurt competitiveness. The sharp, 90-percent rise in the capital costs of investing in new equipment since 1981 reflected three major tax actions in the 7-year period—repeal of the investment tax credit, lengthening of depreciation lives, and elimination of the capital gains tax differential.

Restoration of a reasonable capital gains differential as proposed by President Bush will by no means restore our capital costs for equipment to a satisfactory level. But the estimated drop of about 14 percent, according to experts, in such costs would be an important first step in reversing a very dangerous Federal tax policy.

In my written statement, I have a few other comments on the benefits that can flow from this to entrepreneurial activity. I have also a table showing the rates in foreign countries up to date, which you were asking about, and other material. But I want to turn last to the revenue estimate controversy.

Much to do has been made about the disagreement between academicians and government estimators on the impact of the President's proposal on revenues. Let me say two things about that. First, even if the Joint Committee's staff estimates were correct, and I thought Mr. Pearlman was both accurate and humbled in saying, do not assume our conclusion is better than anyone else's. I can here in that spirit today. Even if the estimates are correct, this first step toward competitiveness of cutting capital costs, starting a competitiveness oriented tax policy, would be well worth the taking in my judgment.

Second, my experiences have convinced me that any revenue estimate is suspect, and one extending much beyond 3 years is especially suspect. However, if we take the 5-year period from 1989 to 1993, Treasury estimates a cumulative revenue gain of $16.1 billion from the President's proposal. The Joint Committee estimates a loss of $13.3 billion. Thus, the algebraic sum of the two estimates by highly professional, dedicated government servants is very close to a wash—no net revenue impact.

Given that circumstance, if I were a member of Congress, I think I could easily conclude that approval of the President's proposal for restoring a meaningful capital gains differential, and a competitiveness-oriented tax policy, is in no way fiscally irresponsible and can be viewed by reasonable men as meeting the revenue-neutrality requirements of the Gramm-Rudman legislation.

Thank you.

[The prepared statement of Dr. Walker appears in the appendix.]

The **Chairman**. Thank you, Dr. Walker.

I was looking at that list. One of them prepared by Arthur Andersen & Co.

Dr. **Walker**. We have updated it, Mr. Chairman.

The **Chairman**. Well, this one here—I was looking at the numbers—Australia, maximum long-term capital gains rate, 50 percent. Those in exempt—Canada, 17.5 percent; France, 16; Italy, exempt; Japan, exempt; Netherlands, exempt; Sweden, 18 percent; United Kingdom, 30 percent; Hong Kong, exempt; Indonesia, 35 percent; Malaysia, exempt; Singapore, exempt; South Korea, exempt; Taiwan, exempt.

How do you think that relates to our international competitiveness? One of the things I have been very concerned about is the cost of capital in this country, for building new manufacturing plants and buying new machinery. Apparently, this proposal would exclude those types of investments. I look at the impact on the cost of capital of interest rates and tax policies. I look at the impact of this towering trade deficit; it appears that we have probably seen the full extent of possible gains from the devaluation of the dollar.

Dr. Auerbach, how do you think that affects us?

Dr. **Auerbach**. There is certainly no question that a higher capital gains tax rate, whatever else it does, raises the cost of capital; a lower capital gains tax rate lowers the cost of capital. One should not ask whether a reduction in the capital gains tax rate would lower the cost of capital but whether, if a reduction in the cost of capital is the objective, reducing the capital gains tax rate is the appropriate way to achieve it.

For a variety of reasons, I think there are probably better alternatives available. For example, directly targeting the investments by corporations rather than targeting capital gains would give you the added benefit of giving the incentive, even to assets are held by tax-exempt individual investors. Moreover, such a reduction in the tax burden at the corporate level, I think, would not bring with it a lot of the other dilatory side effects that a differential between the tax rate on capital gains and ordinary income would have.

And finally, I guess I would say that my own research suggests that in the 1980's, despite the very large fluctuations in the tax treatment of capital income, the fluctuations in real interest rates were much, much larger in their impact. I have said before this committee that the best way for you to ensure that the cost of capital is maintained at a reasonable level in this country is to keep real interest rates down by doing something about the deficit. That takes precedence.

The CHAIRMAN. I agree with that. I look at the fact that our prime rate is 11.5 percent here, West Germany's is about 6.5 percent, and Japan's is about 3.4 percent. You want to build a new plant you must factor that into the cost of those widgets or whatever it is you are producing. This is a tremendous disadvantage for our people. So we have to increase savings and try to reduce the cost of money in whatever way we can.

Dr. Roberts, one of your comments. I was thinking about what Senator Bumpers said about new companies starting out and how important it is that we encourage them. I very much agree with that. This is a bit off the track, but with the repeal of the General Utilities rule, why would anyone start in the corporate solution?

Dr. ROBERTS. I think it is certainly true, Mr. Chairman, that individuals who pay income tax are the organizers and the instigators of high risk, new technology based ventures.

There is an appendix in my testimony which is drawn from an empirical study by two professors, which was presented last May to a conference in Canada on entrepreneurship. They find that private individuals account for most of the money for small capitalization new ventures. And they also provide the early money the start-up money, the seed money, the money that it takes to get going. The so-called tax-exempt players do not come in until much later in the stage. So the fact that there is tax-exempt money involved is basically irrelevant.

The CHAIRMAN. Do you think they could——

Dr. ROBERTS. The tax-exempt money does not organize ventures nor does it come up with the ideas.

The CHAIRMAN. Do you think they come in at the mezzanine level?

Dr. ROBERTS. The table that these professors—I have not independently verified their work—but the table that these professors provide shows quite clearly that the seed money, the startup money, the small capitalization ventures are all dominated by individuals who pay taxes. It would have to be that way because, you know, some pension fund that is going to make some investments, maybe gambling to improve its relative performance, is not going to be the origin of the idea of the investment.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Mr. McIntyre, let me ask you a question. You and I have been through this on this committee many times, more often allied than not, and reading your testimony I cannot tell whether your principal objection is, the rich get richer—assuming this makes money at all for the government—because again, if it does not, apart from Mr. Walker I do not know many people that will support the proposal if it does not raise money—I cannot tell if your objection is the rich get richer, or your principal objection is the distortion of investment because of the tax shelters that come with capital gains.

Mr. McINTYRE. Well, Senator, it is awfully hard to assume, for me at least, that this raises revenue. If it did, I think still the distortions of investment would be significant enough, the distortions in the tax distribution would be significant enough, that I would be against it. But the assumption here that it raises revenue, I think it is preposterous. If this really works, if the Treasury Department can be trusted on this one and trusted on its previous estimates, then I guess we have solved the Gramm-Rudman problem. We will just cut capital gains taxes in even years and raise them in odd years.

Senator **Packwood**. Well, let me ask you about the distribution, taking into account the theory of the Laffer curve. If you tax people earning $200,000 or more 100 percent you will not raise much money. Not many people will earn going to make over $200,000 at 100 percent tax rate. If you tax them zero, you do not raise much money. So some place between zero and 100 percent is an optimum tax rate that will get the most amount of money for the government.

Mr. **McIntyre**. That is right. If you remember back in 1978 we were told that the optimal capital gains rate was 28 percent.

Senator **Packwood**. I recall that. If somebody knew actually where the optimum point on the curve was, they should not be here testifying today. They ought to be off doing something else and making a pot full of money.

But if you were to cut—let us take the $200,000 example and the 100 percent tax rate—if you cut the rate to 90 percent, you may get some money from people making over $200,000. So the government would raise some money. But clearly, they would raise it only because some of the rich decided to make over $200,000. So the rich would also be the beneficiary. You would also, therefore, skew your tax table—I guess you would call it—slightly more favorable to the rich, because they would now have money or make money that they were not making otherwise.

But since we would not be taxing them at a 100-percent rate, they would get to keep some of it. So that would tilt the proposal toward the rich.

Mr. **McIntyre**. I suppose that is right.

Senator **Packwood**. And at 80 percent they might even work harder if they get to keep 20 percent of their money.

Mr. **McIntyre**. Actually, they quite conceivably would work harder at 90 percent than at 80 percent because with getting to keep so little, they would have to work harder to maintain their lifestyle.

Senator **Packwood**. Well then they would work harder at 95.

Mr. **McIntyre**. I mean, that certainly is the effect we have seen on savings. That is an important thing to note. That is what happened in the——

Senator **Packwood**. I am going to come to savings with Dr. Walker in a moment.

But what I am getting at is this: If indeed the proposal raises money—and I understand your concern and I have some misgivings whether it raises money—why should you and I care in terms of the distributional effects if it raises money from the rich disproportionately because they will make more money, by increasing their capital gains realization. Why do you and I care? Does the country not come out ahead given that?

Mr. **McIntyre**. If we have more selling of stock as a country we will be ahead? I do not think so. I do not think it is much of a gain for the country.

Senator PACKWOOD. I mean, but why do we care whether there is more or less selling of stock if the government gets more?

Mr. MCINTYRE. Well, we care because if this will reinvigorate the tax shelter industry. I care a lot about that.

Senator PACKWOOD. No. I am just talking now about the distributional effects. I am aware of the tax shelters that benefited from capital gains and I am delighted we shut them off. And that is why maybe I am more impressed with an indexing theory than I am other ideas.

But it is the distributional effects I am curious about because I sense a certain almost animosity toward the wealthy.

Mr. MCINTYRE. Not me. Some of my best friends make too much money. [Laughter.]

Senator PACKWOOD. Make too much money?

Mr. MCINTYRE. Way too much but I love them anyway.

Senator PACKWOOD. But why should we care if there are 100,000 stock transactions instead of 40,000; and if on the 100,000 the Federal Government collects more money?

I see Dr. Auerbach is——

Dr. AUERBACH. If the situation as you have described it is really true, if you really are collecting more revenue, then why should you begrudge the wealthy more income if they also are paying more taxes. The problem that I see is that although revenue as calculated from capital gains taxes may be going up, if one did the calculation a bit more carefully and looked at other points in the tax system, as in the tax shelter example, you are not really raising revenue. You are raising capital gains tax revenue.

Senator PACKWOOD. And losing it elsewhere.

Dr. AUERBACH. And you may very well be losing it elsewhere. And if, in fact, you are losing it elsewhere and raising it in capital gains, then the condition that you established is not met and, in fact, the tax payments by those individuals would be going down. And so, it really goes back to the question of revenue estimation again.

Senator PACKWOOD. Dr. Roberts, let me ask you a question. In your testimony, you had that interesting table on the income distribution of capital gains beneficiaries. Do I understand your table to be based upon those who have continual income over a certain amount, over some period of years, rather than a one shot $100,000, $200,000 transaction?

Dr. ROBERTS. That is right, Senator. If you take the Internal Revenue Service's 1985 individual tax model file, the public use sample, you see that people earning less than $20,000 in terms of recurring income receive a larger proportion.

Senator PACKWOOD. Yes, but that is recurring over what period of time? I am not familiar with that table.

Dr. ROBERTS. I am not sure.

Senator PACKWOOD. It would have to be more than——

Dr. ROBERTS. You have some Treasury people still here. We could ask them.

Senator PACKWOOD. It would have to be more than 1 year, obviously.

Dr. ROBERTS. Oh, yes.

Senator PACKWOOD. Or you would not know if it was recurring.

Dr. **Roberts**. Right. You see, this argument that the rich are the primary beneficiary of capital gains relies on a very peculiar definition of rich. I would even say it is dishonest. It includes, for example, a businessman who has worked all his life and now he retires and sells his business; and on the sale of his business that year his income jumps up several hundred thousand dollars because of the capital gain. Of course, next year his income goes back down to middle class standards. Somebody else retires and sells a business.

So if you take that kind of measure of capital gains, then you are going to come to the conclusion that the rich have all the capital gains. But, of course, they are not recurring gains.

Senator **Packwood**. What you are saying is——

Dr. **Roberts**. You take recurring income, because that is exactly what the IRS data says—now, unless they want to repudiate it—it says that those income groups earning under $20,000 receive a larger percent of all capital gains than those earning over $200,000, and, I think, it is about 50 percent of all capital gains that go to people earning less than $60,000.

So the capital gains are not some property of the rich. That is just hokum. There is no basis in fact for that statement, not if you use recurring income which is what you have to do.

Mr. **McIntyre**. Senator Packwood, I think I can explain that table to you. What it is is income not counting capital gains. It is also income that has been reduced by the various tax shelters that are in the law in 1985. So when you have this so-called "under $20,000 people" in this table, many of those people are making a quarter of a million dollars a year. As you recall, before tax reform, half of the wealthiest people in the country were paying less taxes than families at the poverty line.

So those people in his group, which he calls their recurring income, it is their recurring tax shelters that puts them there and it is a very distorted table.

Senator **Packwood**. I do recall very specifically when we did the tax reform bill and lowered the rates, we wondered how—when we were dropping off people, basically, making under $12,000 or $13,000—there could be some making $5,000 or $10,000 whose taxes went up and it is for the very reason you state. That was not their sole income. That was basically what we found on the IRS returns. This was their taxable income. That is all they had taxable. They were actually quite wealthy.

Dr. Walker, let me ask you a question. Charlie and I have know each other for 20 years, ever since he was Under Secretary of the Treasury.

In 1981, I think I was a co-sponsor of your bill, the 10-5-3 proposal. I think Senator Bentsen was also. And it seems to me in 1981 we did almost everything that you advocated, or pretty close to it, in terms of IRA's and changing depreciation rates. In terms of almost everything else in that bill, if there was ever a Charlie Walker bill that was it. Would that be a fair statement? Or as close as we have come in the 20 years you have been watching Congress.

Dr. **Walker**. Recent memory is more vivid to me—what has happened since that time.

Senator **Packwood**. But I do recall, because I went back and checked your testimony, that you predicted that savings was going to go up tremendously and all savings did was go down. Well, you did say that savings would go up?

Dr. **Walker**. I thought savings would go up.

Senator **Packwood**. I did, too and it just went down, down, down until it finally reached its lowest point in 1986. Then we got rid of the IRA's and for the first time in 1987 it went up, after IRA's became nondeductible. I do not understand.

Dr. **Walker**. Well, I think it is too much of a short run relationship there to speculate about much. There has been a lot of analysis as to why the savings rate has dropped so sharply in the United States in recent years. Are you talking about personal savings or are you talking about net national savings that includes business savings?

Senator **Packwood**. If you go on net national savings it is not quite as bad because they have not fluctuated percentagewise as dramatically as personal savings.

Dr. **Walker**. It is pretty bad. It is less than 3 percent. A big factor in net national savings has been raising the taxes sharply on business income because a big part of overall national savings is business saving.

One factor that had not received enough attention in this respect—and economists have a lot of explanations—is the propensity of younger people to spend more. Michael Boskin has done work indicating that if a person was born before or after 1939, it makes a big difference as to the amount he or she saves.

When you add up all the tax actions taken by this Congress during the decade of the 1980's adjusted for current dollars around 1985, you will find that the total tax bill for individuals has been reduced by $1.5 trillion. This includes the 1981 Kemp-Roth, and more importantly, it includes the indexation of individual income taxes that was added to the President's proposal in 1981.

Furthermore, you will find that in pure dollar terms, a very big portion of that $1.5 trillion went to people in the middle and lower income areas. In recent years we have taken many of those off the books. Those are people with very low savings propensities and very high propensities to consume. So I would argue very strongly that the tax cuts on individuals and the increased tax increases on businesses—and businesses tend to save much more at the margin than individuals—has been a major factor in the low savings rate.

I thought we could replicate 1963 when John Kennedy and Lyndon Johnson pushed through a supply-side tax cut—it was very similar to Kemp-Roth—across-the-board marginal rate cuts. In 1964, 1965, 1966 we had a big increase in individual saving and the private saving rate went up very significantly. I thought that would happen again. It didn't. It went the other way.

Senator **Packwood**. And you are saying the increase in 1987 when we went from 3.2 to 4.2 on savings——

Dr. **Walker**. Individual savings?

Senator **Packwood**. Yes, personal savings as a percentage of disposable income, not as a percentage of GNP. They do track each other. It is just a different percentage. Savings as percentage of disposable income went from 3.2 to 4.2 in 1987. Then it has, as you look at 1988 and you take it month by month, gone up rather significantly again. In January it was at 5.8 percent. I do not know if this is just a temporary fluctuation or whether it is the aging of the population, as some people say that older people save more. But indeed it has started back up the other direction.

Dr. WALKER. I hope it continues up. We need it very badly. Otherwise, I think we have already got cost-push inflation going again. It can turn into a real problem if we do not do something to decrease internal consumption.

Can I make just a couple of comments on some of the things that I would like to get in the record?

The CHAIRMAN. Yes. Go ahead, Dr. Walker.

Dr. WALKER. Mr. McIntyre said that we said in 1978 under the Steiger bill, that 28 percent would be the maximizing rate on capital gains. We never said that. We never said that at all. We said 28 percent is a lot better than 50 percent; and that was the basic reason for our support.

I was going to make the point and Senator Packwood made it better than I could. There is a maximizing rate somewhere since this is a voluntary tax—you do not pay the tax unless you take the realizations. The pragmatic question is, where is it? Is it closer to 28 percent or closer to 15 percent?

You asked Mr. Ross, is there a basis for the 15 percent? There is a basis for the 15 percent. The American Council for Capital Formation sponsored private research on the revenue maximizing rate. We asked economists to take another look at it and Prof. Lawrence Lindsey pulled together five studies which included Dr. Feldstein and others; he concluded that the maximizing rate on the basis of their cross-section time series-analysis was somewhere between 9 and 21 percent. And so the 15-percent solution, as we called it at the American Council for Capital Formation, was what was proposed and later endorsed by President Reagan and Vice President Bush.

The CHAIRMAN. Whose studies were those?

Dr. WALKER. The outside studies were pulled together by Prof. Lawrence Lindsey of Harvard, an associate of Dr. Martin Feldstein of the National Bureau of Economic Research. Professor Lindsey has more recently have concluded that an 18.5-percent rate is revenue maximizing. Mr. McIntyre made quite a case about the Canadian situation, reflecting large realizations. The Canadian rate is 17.5 percent. So if we are taking Canada as the end-all and be-all, then the rate looks like to be a lot closer to the 15-percent proposed, than what we have now.

But as Mr. Pearlman said, this is an issue on which reasonable men can differ. But these studies were authored by some very solid academicians and Dr. Boskin himself paid very close attention to the Treasury's preparation of these estimates.

The CHAIRMAN. Dr. Walker, you are going to have to summarize.

Senator PACKWOOD. Let me read just one paragraph, though, if I might, Mr. Chairman.

The CHAIRMAN. All right.

Senator PACKWOOD. Because these relate to the Feldstein and the Lindsey studies. This is from Mr. Pearlman's testimony. He takes the two studies, shows how far off they were and then concludes as follows:

I present these two examples not to criticize the two publications specifically, or the quality of the academic literature in general. There is no question taxpayer response to a change in the capital gains tax rate is inherently difficult to address empirically. Rather, I refer to these two examples to suggest that the results of some of the studies predicting high elasticities lead to conclusions which are sufficiently inconsistent with history to lead our staff to discount them totally when arriving at revenue estimates.

And those are the two studies that you are referring to.

Dr. WALKER. Those are the studies I am referring to and they are very distinguished scholars. Unfortunately—was this Mr. Pearlman's statement?

Senator PACKWOOD. Yes, page 10 and 11.

Dr. WALKER. We would like to respond to that for the record. In the original statement they put out a couple of weeks ago, they did not make these points so that we could prepare our rebuttal to it.

The CHAIRMAN. All right. You will be allowed to give us a written answer on that.

Senator Symms.

Senator SYMMS. Thank you very much, Mr. Chairman.

Gentlemen, I thank you for your statements here this morning. I have several questions but I will try to start, Mr. McIntyre, with asking you a question. That is, your main theme has always been fairness in a fair tax system. So, assuming that, and for example, if someone were earning $20,000 a year and yet would be taxed as though their income were $25,000 I would assume then that you would agree that this is unfair?

Mr. MCINTYRE. You mean if they filled out their tax form incorrectly or what?

Senator SYMMS. No, I mean if they were taxed unfairly. That they income was $20,000 but they were taxed as though it was $25,000. I would assume you would say that is unfair.

Mr. MCINTYRE. Well, I guess you are talking about indexing gains and the trade off there, as you know, in 1986 was that indexing was seriously considered in the Treasury Department's proposal but it required a much higher top tax rate to work. It required a series of very complex adjustments on interest deductions and on deferral of gains and was finally rejected by the committee because it was just too hard to deal with.

But if you want to reconsidering indexing as Dr. Auerbach has suggested——

Senator SYMMS. Would you agree with that?

Mr. MCINTYRE. I think it is worth reconsidering if you want to have a higher regular rate of say, 40 or 45 percent.

Senator SYMMS. But you still would agree, though, that you are taxing people on phony gains if it is just inflationary gains and the fixed prices go up.

Mr. MCINTYRE. Well, you are if these people never borrow any money and therefore do not have any phony interest deductions, if these people are not deferring tax on the gain for a long period of time before they cash it in. When you do the arithmetic on the whole thing, the gains are not nearly as phony as they look.

Senator SYMMS. Well, I guess that is——

Mr. MCINTYRE. That is why, I mean, there are a lot of people out there who are spending great deals of money with these phony gains and living lives of luxury. If they are phony, they are certainly enjoying themselves.

Senator SYMMS. Do you care to comment on that, Dr. Roberts?

Dr. ROBERTS. I do not have anything against the accumulation of capital because it is the main determination of the productivity of labor and of labor's wages. So I do not think we can have a tax system that simultaneously feels it has to punish success and then we sit around and cry about our competitive position or productivity or something else.

So as long as we are going to have a tax system driven by envy, we are going to have all of these problems that you gentlemen are always wringing your hands over. And as I said in my statement, I think we are doomed to continue to cut off our nose to spite our face. It is just the nature of the sort of modern, intellectual frame of mind.

Senator SYMMS. Let me pose a question to you this way: Are you saying—which of these two motivations is the most powerful in politics—the pursuit of justness and fairness in the society or else the pursuit of envy or greed that special interest groups try to make themselves better off at the expense of other groups? Is that what you are trying to say?

Dr. ROBERTS. If I look at the tax code, I would have to say envy won. If I look at the tax code, I have to say it is driven by envy. It is not driven by fairness. It is not driven by prospects of success, opportunity. You have a tax system, as I said, that is extremely biased in its treatment of saving and investment.

There have been studies and proposals to change it. One I eluded to in my testimony was in the "Blueprints for Basic Tax Reform" submitted by the Treasury in January 1977, which confronted this issue of the extraordinary bias, discrimination, and unfairness against saving and investment in the code. We have never confronted this issue legislatively.

I would like to see this committee reopen that and hold hearings. And let us find out if we can get a tax system that lets people succeed or if we have to have one that panders to envy. The one we have now panders to envy. It is that simple.

Senator SYMMS. Dr. Auerbach, would you like to comment on that?

Dr. AUERBACH. Well, I do not think I have so eloquent or grand to say as either of the previous speakers did.

Senator SYMMS. Is there not a good reason for this Congress, though, to reduce the capital gains tax in terms of encouraging capital investment and saving and investment?

Dr. AUERBACH. I think arguments have been made. Dr. Walker made some of the arguments this morning. I think one could make much stronger arguments about the overall rate of tax on capital income.

For example, about moving to a consumption tax; about having investment incentives. I think arguments for such proposals are on much firmer ground than arguments for reducing specifically the rate on capital gains and realizations.

Senator SYMMS. Well, Dr. Walker, on the administration's bill, as I understand it, that they sent over—which I sponsor two bills to do this—their bill is much less pared down than the—I think it is one of the Senators that has introduced a bill to include all capital assets.

Do you think there should be discrimination in the capital assets or should we reduce all the capital gains rate of taxation for any asset?

Dr. WALKER. I would prefer reducing it across the board. But the Treasury was intent upon producing a bill that would limit assets and assure there would be a revenue increase. And if that can get the job done, I would go along with that in the short run.

Senator SYMMS. I think my time has expired. But just if I could, Mr. Chairman, follow just slightly.

It would seem to me like that politically it would be better politically to include everything rather than just financial instruments and stocks and bonds and so forth for the arguments that some of you made here already this morning.

Dr. WALKER. Well, they have housing and land in there. The rest of them—the collectible people—do not seem to have that much political attraction.

I do not see why we do not reward people that make good art and paintings and so on. That is part of a great society. But we are not going to let them get the capital gains.

Mr. MCINTYRE. My wife is an artist; she does not want it.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Well, I think it has been productive and we have certainly had different viewpoints and that is what we need as we try to evaluate this. I am most appreciative of your attendance. Thank you for your contribution.

[Whereupon, at 1:05 p.m., the hearing was adjourned.]

REVENUE AND SPENDING PROPOSALS FOR FISCAL YEAR 1990

WEDNESDAY, MARCH 15, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
WASHINGTON, DC

The hearing was convened, pursuant to notice, at 10:05 a.m., Hon. Lloyd Bentsen (chairman) presiding.

Also present: Senators Baucus, Packwood, Chafee, and Heinz.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS

The CHAIRMAN. This hearing will come to order.

Mr. Trier, if you would come forward and take a seat, please.

As we saw yesterday, there were some very strong differences of opinion about the long-term effects of capital gain tax rates, the responsiveness of investors to the level of tax on capital gains, and whether a cut in the tax rate would mean a net revenue loss or a net gain to the Treasury. I want to be satisfied that if we do make a change in capital gains, we will not worsen the Federal budget deficit over the next several years.

Cutting that deficit is a major responsibility for us, and this committee will play a big part. I don't want us to pass laws that are going to help us next year and then haunt us for years to come. If we have trouble meeting the target of Gramm-Rudman this year, imagine what it is going to be like next year when that target is $64 billion. It is going to be even more difficult.

Today, we are going to be looking at the rest of the administration's revenue proposals. I want to take a close look at some of their proposals to increase revenues, particularly the proposals to extend the Medicare payroll tax to State and to local government employees and to repeal the tax reduction trigger for the Airport and the Airway Trust Fund. The administration is looking to them as possible sources of revenue.

They have come up with a budget that assumes $13.5 billion in new revenues for the next fiscal year. But look at the proposals they are talking about: we have recently rejected one of them; another would require the committee to reverse a decision it made just 2 years ago. When you take these two and put them together with the capital gains proposal, you already have a gap of $7.5 billion to plug. And, frankly, I find it troubling that the administration, instead of showing leadership on this issue, is effectively leaving it up to the Congress to fill that gap.

The Medicare payroll tax proposal is particularly troubling. It is regressive. It is one that the Reagan administration proposed in the past, now, the Bush administration is proposing it. I really think they have their work cut out for them in selling that one.

The proposed repeal of the Airport and Airway Trust Fund trigger is a classic example of budget smoke and mirrors. We have a trust fund that is not in deficit. The money is there to improve the quality and the safety of air transportation, something that is sorely needed today. But, the administration declines to spend the money, not in order to reduce the deficit, but to make it appear that we have reduced the deficit.

The committee put that trigger in 2 years ago to ensure that the money in that fund doesn't just sit there; the taxes would be cut if the revenues they provided were not used for their intended purpose. The committee thought then, and I still think now, that it is better to reduce those taxes than to let the money sit in that fund to enable the bookkeepers to say that the budget deficit is really lower than it is.

I must also say something about that duck test of Dick Darman's. I am at a loss to see how this proposal to repeal a tax reduction, or for that matter, the Medicare payroll tax proposal, which would raise an average of about $200 per affected employee, constitutes anything but a tax increase, or a duck if you prefer.

While the administration's budget includes some tax proposals that just aren't going anywhere, others speak just as loudly by their absence. We will want to question the administration to see whether they intend to let some critically important provisions in our tax law, such as the mortgage revenue bond program, simply expire at the end of the year.

I agree with the President on the need to make the credit for research and development permanent, and I certainly support the incentives for the energy industry. But, given the questions I have about the revenue effects of the capital gains proposal and the nature of the other revenue in the President's budget, I am not sure we have a way to pay for them.

I know very well the political constraints that the President is operating under, given the "read my lips, no new taxes" pledge that he made during the campaign last year. But, I must say in all candor, after having gone over this budget, I think the President is going to be very hard-pressed to keep that pledge.

I am going to do my best to help him, but it sure is hard to see how those numbers are going to add up.

Now, Mr. Trier, as a Tax Legislative Counsel for the Department of the Treasury, I want you to try that on for size.

STATEMENT OF DANA TRIER, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. **Trier**. Thank you very much, Mr. Chairman,

The **Chairman**. Let's limit your testimony to 10 minutes; then, we will get to the questions.

Mr. **Trier**. Certainly. Why don't I really divide it into three or four parts and try to briefly hit the highlights. The first would be to be responsive to your points with respect to the extension of Medicare coverage and the airport trigger.

The second part would be to say just a little bit about our initiatives in the R&D area, et cetera. Third, to hit the highlights—some of which you have mentioned—of those proposals that we are not making, or stated otherwise, that we have decided not to put in the budget even though they are expiring provisions. And then, finally, just say what has motivated us and our budget proposals generally.

First, with respect to the extension of the Medicare coverage and the Airport and Airway Trust trigger, both of which are provisions and things which were discussed during the years of the Reagan administration as you pointed out. I would Say two things in response to your comments. One is that we continue to believe pretty strongly that the general case for extension of Medicare and hospital insurance to State and local employees is quite strong. We do have a duck issue with respect to that, but I guess that I would look at this as one of those cases in which there really is an articulable basis for saying that this is not a true tax increase. The basic concepts we have here is that some State and local employees benefit from this in any event, and to the extent they are not, they are probably most rationally treated as under Medicare. And to have them be subject to the tax is really simply, you could view it as part of a user fee sort of theory. It is not really a tax increase, per se, in the general sense of the term.

With respect to the Airport and Airway Trust trigger, obviously our proposal does have the effect of increasing receipts. It does have the effect of making the numbers come out better. But our plans continues to be consistent with the underlying notion, or policy underlying the trigger, which is that we do in fact intend to spend the money with respect to Airport and Airways facility modernization that would come from allowing the trigger to go into effect. And if that is true, admittedly that does give rise to increased receipts in an overall way. But we are really permitting this to be the source of revenue for an expenditure that is part of the infrastructure of the economy. As far as our country, in general, you are going to have to spend.

So I understand your points but I would have to respectfully disagree with them.

From the perspective of the spending side, the tax expenditure side of the budget proposals, we really have, a basic threshold decision. And the threshold decision is where are we going to be in favor of things which do have some negative, perhaps revenue impact, but on the other hand, we think can be supported. We come into that with the same perspective that I am sure we all have now, that is, we are in a period Of budget austerity, and we have to be very selective. We have to establish clear priorities and we have to make sure the whatever tax provisions that favors something are very efficient. They really have their effect. And it is establishment of the priorities and efficiency of governing where we have made our draw, where we have drawn our lines.

The R&D credit we continue to believe is an extremely important thing. We are in agreement on that. We think that to be able to make the credit permanent, to be able to change its structure so that it has the impact of being very efficient on how much it induces extra research is very important. And those policy considerations underlie the Bush administration's proposal in that regard.

With respect to the oil and gas incentives, energy incentives, that are the same sort of considerations. Although there, our concern is that because of the recent economic events, this is an area that at least temporarily needs a boost, and we think it is quite important for the economy in general and for the defense needs of the country.

The enterprise zone initiatives fits into, we believe, a strong social policy with respect to urban areas, and the child care credit as well.

There were, however, some proposals which were not made and in which case we decided to let provisions expire. And I would think that it could be safely said with respect to almost all of these, the Bush administration supports the basic objectives. But what we decided was that for efficiency reasons, or other reasons, that the tax proposal is not justifiable. I think two or three of the most debatable in this regard are the most interest to you—the mortgage revenue bond provisions—we would permit to expire. As you know, during the Reagan years and now starting with the Bush administration, that has been a pretty consistent Treasury position.

The basic theory there is not that we are against housing, and not that we think that this is anything other than a very strong, important social policy to encourage housing, but we think that the tax exempt financing and mortgage revenue bonds is simply a quite inefficient means of stimulating housing. And the basic problem there is the inefficiency of tax exempt financing in general; that not all the tax revenue itself goes to the ultimate beneficiaries, either because the middle men get them or because of the difference in rates under which people benefit.

The second one which, for us, is a much closer call, is the low-income housing credit. As you know, the extension of that beyond its expiration this year was not put in the budget, despite, of course, the fact that we strongly feel the need to increase low-income housing.

But with respect to low-income housing, at least at this point we continue to have a concern that, again, this tax expenditure is not acting efficiently. In some ways, you have the same problem you had with respect to mortgage revenue bonds. You have a middle person that gets some of the benefit. In other ways, the problem is trying to determine whether you have really stimulated people that would not otherwise do a low-income housing deal to do it.

And, third, we have some question as to whether the housing projects are actually run in a way such that after the transaction is completed the project will for its life increase or help out the low-income people.

I would also like to say a few words about a couple of other proposals. As is well known now, at this point in time we are no longer in favor of the extension of the special breaks for thrift institutions and banks. Basically, the reason for that is that it is twofold. First, because, as with all these tax provisions, there is a significant inefficiency in the way these provisions operate. But, second, we really look at the Bush administration proposals with respect to troubled thrifts as supplanting, or, in effect, replacing the role of these provisions and being the best and most direct way of dealing with this very bad problem.

There has also been a significant amount of interest expressed with us at Treasury with education and revising the Educational Assistance Program. There again, at least the data that we think is the best, seems to indicate that it is a pretty inefficient subsidy to educational assistance, and, moreover, that it really is helping out some people significantly more than others.

So we have had to draw up some tough lines. We are all in a very difficult situation. I understand the concerns that you have expressed at the outset, Mr. Chairman, but this is the rationale for the lines that we have drawn in this regard.

I would be happy to take any questions you may have.

[The prepared statement of Mr. Trier appears in the appendix.]

The CHAIRMAN. Why don't you go ahead since we don't have the other members are not here yet, if you want to take another 5 minutes.

Mr. TRIER. Why don't I say a little bit more about the specific proposals, then, that we have made. First, with respect to the R&D credit, just to get across the basic concept that we have. As I said earlier, there are several different policies that underlie our proposal. First of all, we think this is a true priority. Getting the country's growth going again, reestablishing our technological superiority is an extremely important objective of the administration and we believe of the country as a whole. For that reason, this is a place that we think the expenditure of money is important.

The important thing about our proposal, which is, as you know, very similar to Senator Danforth's proposal, is that we think it makes the R&D credit even more effective. There are several aspects of that. The first is that there is the permanency of it. For planning purposes, that is an extremely important point. Second, unlike the existing provision, this would be based in general on a fixed base. As has been the case in the past, it would be an incremental credit. It would be to the extent to which you could increase your expenditures. But the base would not be based, the R&D credit expenditures that you had in previous years for which you took the credit, So you don't have this strange phenomenon in which doing something now actually hurts the extent to which you can get a credit later on. And we think that is a very important aspect of it.

Third, to encourage startups, you would not have to yet be in a trade of business when you take the credit. So that is a very important proposal that we have and that is the rationale for that proposal.

With respect to the child care credit, we have spent a fair amount of time in actually drafting that. Hopefully, ill have that introduced sometime in the next week or two. Again, there are other Senators with similar proposals around.

I think to understand this proposal we have to understand that we really think that this is part of the kinder-gentler America theme, and that, hopefully, this will be reasonably administrable because it is based conceptually on the earned income credit. It is a refundable credit. A lot of the paper work that is associated with it is the same paper work that employers may otherwise be used to, or accused to. And, hopefully, that will be adopted in some form.

Are we ready for questions?

The CHAIRMAN. I understand that, prior to your Government service, you served as a bond counsel. Is that correct?

Mr. TRIER. That is true, Senator, as a tax lawyer on tax exempt financing transactions.

The CHAIRMAN. Well, on mortgage revenue bonds, you stated that the administration feels that tax exempt bonds are a very inefficient way to try to promote housing. Isn't it true that, under the 1986 Tax Reform bill, we went a long way in trying to correct that inefficiency?

In addition, if you agree that access to affordable housing is a problem, isn't it irresponsible to propose eliminating that credit without coming up with an alternative?

Mr. TRIER. Well let me address that question in two ways. One is that it is true that I did quite a bit of tax exempt financing work, and it is always with some trepidation that I get out there and testify against my own practice. On the other hand, I would say two things with respect to it. Two-thirds of my practice was low-income housing transactions and mortgage revenue bonds in the bond area. Based on that experience, I in fact have some skepticism about the efficiency of those provisions. That does not mean at all that I am against tax exempt financing in general. There really are at least three different types though. There is the general obligation type. There is the type where you are talking about the sewers for a city, the infrastructure financing, and then there is the third kind where you really do have a private interest that owns it, but you hope that it is an incentive to do something that is for the public good.

And I thought in practice, and continue to think, that there really are efficiency considerations with respect to the mortgage revenue bonds, low income housing financing, and in fact, low-income housing credit.

With respect to each of these, that does not mean that the administration doesn't think that they are important goals. For example, with respect to housing, our own view is that the most efficient thing is to give vouchers to the low income people themselves. You take out that layer of middle people by doing so, thereby making what is in effect an expenditure of governmental funds more efficient. And that really is our alternative with respect to mortgage revenue bonds.

With respect to the low-income housing credit, I would have to say that I think we generally view that as a much closer call.

The basic notion of the structure of the low-income housing credit by which you put in one place a bunch of different incentives we believe is a good thing. And we think the 1988 act made the low-income housing credit more efficient. But in this difficult process of drawing lines, we decided, at least initially as part of the administration budget, that as we see it at this moment, we do not think the case could be made for putting that extension in the budget.

The CHAIRMAN. Well, let me ask you another one. Let's talk about the trigger for the Airport Trust Fund.

Mr. Trier. All right.

The Chairman. You deem that to be a user fee. How can it be a user fee when you don't spend the money?

Mr. Trier. I don't want to quite call it a pure user tax, but it is something that——

The Chairman. Well is it a duck or isn't it a duck? It sounds more like a waffle.

Mr. Trier. The ultimate decision as to whether it is a duck rests above me, but I can't speak for the expenditure issue directly obviously. That is not the position that I have. But it is at least my understanding that the assumption underlying this proposal is that in fact in the short or the long run these monies will be needed and will be expended for the purpose for which they are designed, which is the modernization supports.

The Chairman. Well, that is not what we have seen. We did not need the Eastern strike to find out how much trouble we are in. We have got some real problems relating to modernizing our air transportation system.

Mr. Trier. I understand that.

The Chairman. I also noticed the proposal on the so-called tax gap. The administration claims $3 billion can be raised over 5 years through improved IRS tax collections by adding 1,360 new personnel at the IRS. That is very interesting to me. I think it is rather ironic. I happened to notice it in President Bush's budget because I remember some of his comments during the Presidential campaign——

Mr. Trier. I recall it too.

The Chairman. All right. He criticized proposals to increase revenues by improving IRS tax collections as seeking—in his own words—"to put an IRS agent in everyone's kitchen." Has the President changed his mind?

Mr. Trier. I don't think he has changed his mind in the desirability of putting an IRS agent in everyone's kitchen, I do think that perhaps there is a difference of degree between our proposal and the extent to which we rely on it and that of you and Mr. Dukakis.

But I would admit that basically that we do view a relationship between the amount of funding for the IRS, and in fact the amount of revenues that can be raised in it. Up to some level, given the incredible difficulty that they have, and the enormous complexity of audits and indeed the administration of law now, up to some level, we believe it is important to fund them more. And then, in fact, that will have a positive impact on our revenue situation.

The Chairman. Well, I have seen the change in attitude on assault rifles, I was just trying to see how far this thing goes.

Let me get to another question. I see under user fees that the administration is talking about charging taxpayers for calls they make to the IRS with questions on their taxes. I would be interested in knowing the nature of that fee. It seems to me that those that are calling are those that are most concerned and want to comply. And then I read that many of the IRS's answers are wrong. Would taxpayers get a discount for a wrong answer? [Laughter.]

Explain that to me.

Mr. **Trier**. All right.

The proposal as I understand it at this moment is a pilot program.

The **Chairman**. No. We were talking about pilots on the trust fund.

Mr. **Trier**. It would be a test program, let's call it, as whether this user fee is an appropriate response to what is in fact a fairly significant load on the IRS. Not just to answer questions of the taxpayer, assistance calls, but more directly to answer a variety of more complex questions, or tell them where schedules are, or what forms are available, that type of thing.

If the pilot program did not work out, if in fact it just was not worth it, did not seem fair, whatever, of course, it would not be finally adopted. It is an idea for, again, in a sense, imposing a user fee.

With respect to the points you raised, which I think are very fair, which is, one, whether you are really discouraging people that are trying to be honest and complying, but charging them something, I think that is a problem. I think that is one of the things that should be—one of the objectives or considerations that should be taken into account in assessing whether this pilot program is a good thing or not. However, there are other aspects of the tax administration. You charge user fees for ruling requests. And, of course, the people that are coming to IRS for the ruling request are good people in general, people who are trying to find the right answer.

As to the accuracy, I think this user fee would probably be something that perhaps apply not just in the cases of asking legal questions, but obviously making the responses more accurate was a major objective of now prior Commissioner Gibbs, and has to be one of the IRS generally going forward, irrespective of whether this user fee goes into effect.

I, myself, cannot figure out any meaningful way that we can discount it for the answer being wrong. But again, that should be taken into account, I think, in assessing whether it is a worthwhile thing.

The **Chairman**. Senator Chafee.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator **Chafee**. Thank you, Mr. Chairman.

I just wanted to ask one question if I might about the Federal Communications Commission's unassigned spectrum. Has that been explored, Mr. Chairman?

The **Chairman**. No, it has not.

Senator **Chafee**. As I understand that, there will be a competitive bidding process for the licenses to obtain the unassigned spectrum. Is that correct?

Mr. **Trier**. I am not familiar with this.

Senator **Chafee**. Well I notice that is one of the items. I just want to say—to me, I don't know the details of this—but I think it makes an awful lot of sense that when you have something that is limited that it should go to the highest bidder and not parceled out.

A whole host of people make bids, and then somehow there is a selection made.

Mr. TRIER. Yes.

Senator CHAFEE. In our State beaches, for example, if somebody wants to have the hot dog concession, we put it out to competitive bid, and whoever bids the most gets it. And everybody thinks that is a perfectly fair way to proceed. But for some peculiar reason, in giving out very limited broadcasting spectrums, that has not traditionally been looked on as fair.

Mr. TRIER. Right.

Senator CHAFEE. I would encourage you to examine this issue.

Mr. TRIER. I will look into that and get in contact with your office.

Senator CHAFEE. I suspect that that is the President's proposal, and it makes a lot of sense to me.

We have been around and around in so many of these other issues for years. I will not pursue them except that whatever arguments you have—and I have not been here to listen to them all—on some things like mortgage revenue bonds, the R&D tax credit, the low-income housing tax credit, things like that, we just plain have not agreed and that is that.

I understand again you have come in for the Medicare payroll tax.

Mr. TRIER. That is true, sir.

Senator CHAFEE. And I have always supported that. I guess others in this committee have not. And to me it makes sense, because eventually these folks are going to be using Medicare, and I think it is only fair that they should be paying for it.

Those are the only observations that I had, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM PENNSYLVANIA

Senator HEINZ. Mr. Chairman, thank you.

I really don't have a lot of questions because I think the testimony is quite succinct. I do commend you on putting right up front the good news and the bad news, but I do think that we have to get working on the budget very quickly. There are a number of tax issues. And I would like to ask you to take a message back to the Secretary and the President, which is to quickly appoint the very qualified people to the top tax position in Government. I am not only thinking of the Assistant Secretary who apparently there is an intention to nominate, but the IRS itself is, with the departure of Larry Gibbs, leaderless, and I hope it is not rudderless as of now. One month and 2 days from today is April 17. There will be about 100 million taxpayers' returns arriving on your doorstep. And the thought of them arriving and not having an IRS Commissioner is not something anybody ought to look forward to.

With respect to the revenue items in the President's budget, I certainly do support the extension of the R&D tax credit. I think it is very limited and I think it overlooks a lot of things that this country should be supporting. I support the R&D allocation rules, but there are other extender items that I am disappointed that the President has not supported. Of particular concern to me is that the targeted jobs tax credit, which has proved to be an extremely effective tool in providing employers the incentive to hire workers from target groups. It is a program that works, and it should clearly be made permanent. Employee educational assistance should also be extended. It provides workers with a chance to go to school.

Mortgage revenue bonds have provided a means for low and middle income families to afford homes.

In Pittsburgh, that program alone has provided some 14,000 housing units in targeted neighborhoods.

I won't list all of the other expiring provisions. This committee has certainly supported them over the years. While the administration may not support them, I do believe there is going to be substantial support from many of them in Congress and we are going to need your help to find ways to make sure that we can afford them.

I believe also that it is time that we made these provisions permanent so that we do not go through this exercise of arm wrestling and arm twisting every year. It makes it impossible for the programs that we end up supporting to work effectively. They have become on again, off again, and that is a poor way to conduct public policy. You don't favor enacting most tax provisions on an annual, or 2- or 3-year basis. That would drive you and everybody in this country nuts.

What you—and we, in effect—are doing to ourselves and our constituents is to drive them equally crazy with the uncertainty that we create.

Thank you, Mr. Chairman.

Senator CHAFEE. Could I say one word, Mr. Chairman?

The CHAIRMAN. Yes, of course.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Chairman, I was in error when I said that on the R&D tax credit, you have got that in there.

Mr. TRIER. Right.

Senator CHAFEE. And I apologize.

Mr. TRIER. I wondered why.

Senator CHAFEE. No.

The CHAIRMAN. But they made some changes in the provisions and he went into that.

Mr. TRIER. Yes.

Senator CHAFEE. I apologize. I was incorrect in that. And I do want to congratulate you on that, and also on the allocation of the research expenses of multinational firms. That is something we have struggled with. I want to congratulate you for including that also.

Mr. TRIER. All right.

Senator CHAFEE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions, Mr. Chairman.

The CHAIRMAN. Let me ask you about the educational assistance exclusion, which expired. I know this President wants to be known as an education President, and that that is a focus of his budget. You are not recommending the extension of that provision. Do you feel there are enough tax incentives—for education? Would you explain that? It seems to me to be contrary to what the President is hoping to achieve.

Mr. **Trier**. Let me respond to that in a couple of steps, that I think they are basically pretty obvious. The first is, we all are very strongly in favor of increasing the education level. It has got to be one of the highest priorities oF the country.

The question is whether this particular type of tax provision is the proper expenditure for the revenues of the Government to do that. And we continue to believe, that is, we have testified the last couple of years, as people pointed out—this has been said before—that this way of doing it is not, in essence, very efficient, and in fact not very fair, because the people that get the benefits from this subsidy, or this incentive, really are dependent upon their particular employer being situated in a way that this kind of program is provided.

If I were a king, and we had unlimited revenues, I frankly would give individuals each some sort of voucher or tax deduction to support education. It is something that I believe in. And we all realize that that is probably too expensive at this point in time. So the real question is whether this proposal makes sense.

The **Chairman**. Well, you say you are concerned that it is not as efficient as it should be. When you think about the desires of this President, as compared to the previous one—and I mean this President's announced deep interest in education—do you have an alternative proposal?

Mr. **Trier**. I don't think I could state fairly that there is a direct alternative, you know, the voucher type. I think the expenditure of money on education—and I do not know the actual figures in the budget, well I probably cannot know it—remains an important policy objective of the President.

The **Chairman**. Well, let me ask you another one. Let's talk about enterprise zones for a moment.

Mr. **Trier**. Uh huh.

The **Chairman**. You are talking about enacting tax incentives to encourage employment, investment tax credits, and yet you do not spell out what these tax incentives will be. An yet, you know that they are going to cost a billion dollars. How can you know the cost when you do not even know what the tax incentives will be or do not spell them out? How did you arrive at that cost estimate?

Mr. **Trier**. The way it was arrived at, there is a couple points that you are really making in there and they are fair points. One is the structure of the incentives has not been finally determined at this point.

The **Chairman**. But you know it is going to cost a billion dollars.

Mr. **Trier**. The structure of those incentives as it is developed would be designed so that that much is expended.

The **Chairman**. In other words, first you put a price on it, then you try to draft tax incentives that cost that amount. Is that what you are saying?

Mr. **Trier**. That's right.

The Chairman, Are you going to call it a user fee?

Mr. **Trier**. No.

The **Chairman**. I have no further questions.

Mr. **Trier**. Thank you.

The **Chairman**. Thank you very much.

Mr. **Trier**. Thank you very much, sir.

The **Chairman**. Thank you.

[Whereupon, at 10:45 a.m., the hearing was concluded.]

APPENDIX

ALPHABETICAL LISTING AND MATERIAL SUBMITTED

PREPARED STATEMENT OF ALAN J. AUERBACH

Mr. Chairman and Members of the Committee: It is a pleasure to appear before the committee to give my views of President Bush's proposal for a reduction in taxes on capital gains. I appear here as an individual, and my opinions are not necessarily those of any organization with which I am affiliated. My understanding of the proposal's provisions is based on the Treasury's February, 1989 General Explanations.

In my testimony, I deal with a variety of economic issues concerning the costs and benefits of capital gains tax reductions in general, as well as the particular proposal at hand. This is not the first time in recent years that your committee has considered altering the tax treatment of capital gains and, regardless of the fate of the current proposal, the issue is bound to arise again in the future. Therefore, it is important to have a perspective on the broader issues that are relevant to the topic of capital gains taxation.

My discussion begins with a review of the effects of capital gains taxation.

CAPITAL GAINS TAXATION AND ITS EFFECTS

There are four salient features of the capital gains tax as it currently applies:

A. Realization and the Deferral Advantage

Unlike other capital income taxes, the capital gains tax is imposed only on realizations. While interest income and dividend income is taxed annually, capital gains are subject to tax only when the investor *chooses* to incur the tax through an asset sale. This provides the investor with two advantages. First, by delaying the payment of taxes on gains already earned but not realized, the investor in effect receives an interest-free loan from the government that is proportional in size to the unrealized gain; the bigger the gain, the bigger this deferral benefit. The choice of realization date also permits the investor to take advantage of tax rate fluctuations over time that may result either from changing individual circumstances (temporarily low income or high deductions, for example) or changes in the tax law. This enhances the deferral advantage, as investors may not only defer payment of the tax on an unrealized gain but also reduce the tax that is eventually paid.

B. Basis Step Up at Death

There is no capital gains tax paid at death on an investor's unrealized gains. Moreover, whoever inherits the appreciated property receives a basis that is "stepped up" to market value, so that the gain receives more than continued deferral; the tax is simply forgiven.

Characteristics A. and B. have important effects on taxpayer behavior. First, they encourage individuals to hold appreciating assets, rather than assets that provide most of their return in the form of current income. Second, they encourage firms to alter their financial policies, reducing dividends and retaining more earnings to deliver favorably taxed capital gains. Third, they cause a "lock-in" effect, whereby the investor has an incentive not to sell an asset in which a gain has accumulated, even if other factors would cause a shift in investments. Since the size of the benefit of continued deferral is proportional to the size of the unrealized gain, the lock-in effect is most serious for large gains and, typically: assets that already have been held for a long time. Likewise, the benefit of escaping capital gains taxes entirely at death becomes more important over time, as estate planning becomes more of a relevant concern.

C. Limited Deduction of Capital Losses

Regardless of their size, an investor cannot deduct more than 3,000 in realized capital losses in excess of realized capital gains. This provision is really a necessity, given the voluntary nature of realizations. As already discussed, the deferral advantage associated with unrealized gains is proportional to the size of such gains. The same logic applies in reverse to unrealized losses: the larger the loss, the more of an incentive to sell and receive a deduction immediately, to prevent the government from getting a tax-free loan from the investor. Combined with the lock-in effect, this "lock-out" effect encourages a pattern of realizing losses and holding gains, exacerbating the revenue effects of the deferral advantage; an investor with little net accrued loss can still report a significant capital loss in any given year by holding a diversified portfolio and selling assets that show a loss. Under a realization-based scheme, the only solution to this problem is a limitation on the deductibility of capital losses.

Although the net cast by the capital loss limitation may succeed in limiting the "tax arbitrage" behavior just described, it ensnares less harmful activities as well. The point is often made that capital gains taxes discourage risk-taking and venture capital enterprises. This is true, and it is largely due to the treatment of capital losses. The government plays a game of "heads I win, tails you lose" with investors. If the gamble pays off, the project succeeds and the entrepreneur or venture capitalist faces a capital gains tax. If the project fails, the ensuing losses may be recouped only if an investor has sufficient capital gains from other sources.

D. Taxation of Nominal Gains

Capital gains are measured relative to original purchase price, but this price may have been paid many years earlier and may represent significantly more purchasing power in today's prices. An investor with a large realized gain may well have earned no gain at all in terms of real purchasing power.

E. Summary

The current treatment of capital gains encourages investment in assets qualifying for capital gains treatment, even under current law, because of the deferral advantage that remains. However, this treatment also causes a lock-in effect, interfering with the reallocation of capital in the economy. It discourages risk-taking by treating gains and losses asymmetrically, and penalizes investors selling assets following periods of high inflation.

Each of these distortions would be lessened by a reduction in capital gains taxes. Since the size of the tax deferred by choosing not to realize a gain would be reduced if the tax rate itself were lower, the lock-in effect would be weakened. The gap between the positive tax rate on gains and the zero rate of refund for losses would also decline, lessening the penalty imposed on risky ventures. Finally, the overtaxation of real capital gains would be offset by the exclusion of a portion of these gains from the tax base or a reduction in the rate at which gains were taxed.

At the same time, however, such a reduction would worsen other distortions associated with the capital gains tax. The policy would further penalize the distribution of earnings by corporations. It would encourage investors to reduce holdings of fully taxable assets, incur additional debt, and engage in other transactions to facilitate a conversion of fully taxed income into income qualifying for capital gains treatment. Yet none of these costs is inevitable: none of the apparent objectives of a capital gains tax cut require that particular policy to be undertaken. Alternatives exist that are at once more effective and less likely to worsen other distortions.

ALTERNATIVES TO A CAPITAL GAINS TAX CUT

While I am not here to advocate particular schemes, I believe it is useful to illustrate the alternatives that exist and are in many respects to be preferred to a reduction in capital gains taxes for the achievement of particular objectives.

Inflation

The correction for inflation made by reducing capital gains tax rates is a very rough one, since all assets receive the same relief regardless of the extent to which their size is overstated by inflation. Moreover, contrary to the argument one often hears, a correction for inflation is more important for assets held for relatively short periods of time than for those held for extended periods. Put another way, the reduction in capital gains tax rates needed to offset the impact of inflation declines with the length of the holding period. This is a fact, not in hypothesis.

Indexation is relatively straightforward to implement, as the Treasury demonstrated in its important 1984 report on tax reform. It is unfortunate that the indexation proposal contained in that report was dropped and that only the increase in the capital gains rate itself survived. Perhaps the improving inflation outlook in the mid-1980s influenced this outcome, but more recent macroeconomic events remind us that inflation may return in the future.

Risk Taking

One of the Administration's aims in excluding depreciable assets and "collectibles" from the proposed reduction in capital gains tax rates may be to focus the tax incentive on "productive" investment and risk-taking. But it remains a very blunt instrument for this purpose. The Treasury's previous 1985 study of the effects of capital gains taxation pointed out that roughly .1 percent of outstanding corporate equity is associated with venture capital operations, and that perhaps half of this very small fraction of venture-capital equity is held by pension funds and other investors not affected by changes in capital gains tax rates. Reducing the tax rate on all capital gains, even if the provisions were restricted to gains on common stock, would have a benefit-cost ratio verging on the microscopic.

One could limit the windfall benefits of a rate reduction by restricting it to new issues of equity or, at the very least, to equity purchases made after some effective date. Alternatively, if the focus is to be on common stock, an expansion of the class of assets subject to existing mark-to-market provisions could be implemented. Once this were done, and the voluntary nature of gain and loss realizations were reduced, it would be possible to allow a more generous allowances for capital losses.

The Lock-In Effect

There is no doubt that one way to eliminate the lock-in effect is to cease taxing capital gains. Reducing the tax rate moves in that direction. The lock-in effect is not simply a product of the capital gains tax *rate,* however, but also the way that capital gains are taxed. The interest on bonds selling at par is presently taxed at the same rate as capital gains, yet there is no lock-in effect discouraging sales of such bonds by taxable investors. This is because interest is taxed when it is *earned,* not when its recipient chooses to be taxed. If marketable assets are the primary concern, a mark-to-market system would eliminate the lock-in effect *completely,* regardless of the rate of tax. It would be possible to reduce the rate of capital gains tax while moving to a system of marking to market that would maintain or even enhance the attractiveness of such investments while at the same time eliminating the lock-in effect. Whatever the revenue gains from increased realizations caused by a simple cut in tax rates, the gains would *necessarily* be greater under a system of marking-to-market, for the incentive to delay realizations would have been done away with entirely.

Short of such an ambitious change in the approach to taxing capital gains, a more modest way to reduce the lock-in effect would be to tax capital gains at death or at least eliminate the step-up in basis that occurs when assets are transferred at death. The revenue raised by such a policy could be given back through a small reduction in the rate of tax on capital gains, with the net result being a similar incentive to invest in capital assets and a reduction in the lock-in effect. I know that previous attempts to adopt such a policy have not succeeded, but this move would represent an improvement from the economic perspective, and I feel obliged to say so.

Tax Revenue and Tax Incidence

The Treasury has produced estimates suggesting that the president's proposal would raise a small amount of revenue in the short and long runs, losing some during the transition from a one-year minimum holding period to a three-year period. These revenue estimates are based on the Treasury's previous empirical findings regarding the responsiveness of capital gains realizations to tax rates, which predict a high degree of permanent responsiveness, compared to other serious empirical studies. Combined with a tailoring of the proposal that appears aimed in part at making the short-run revenue forecasts more attractive (such as the phasing in of the three-year minimum holding period), one would have to classify these predictions as optimistic.

I find the projections of the staff of the Joint Committee on Taxation to be more plausible. However, there is a great deal of uncertainty about the true revenue effects. The causes of this imprecision are both empirical and theoretical. The empirical problem is that it has been difficult to distinguish long-run and short-run responsiveness to capital gains tax rates. It is clear that capital gains realizations are very sensitive to tax rate changes, but this sensitivity appears in large part to reflect shifting of gains to low-tax years rather than permanent changes in behavior. If a large part of the observed responsiveness is due to timing decisions. then an announced tax rate reduction could lead to a considerable long-run revenue loss, even if a particular year's revenues increase.

From the theoretical perspective, it is useful to ask whether the large long-run elasticities used by the Treasury in its calculations could be generated simply by an increased frequency of realizing gains and a reduction in the fraction of gains held until death. Some simple calculations suggest that the doubling of predicted realizations built into the Treasury estimates would require a considerable speeding up of realizations. For example, if assets appreciated annually at a rate of 10 percent, one fourth of all assets were held until death and never sold, and the remaining assets were sold once every ten years, the annual ratio of realized gains to assets would be 4.7 percent. Doubling this ratio would require that *all* assets be sold and all capital gains be realized *every* year! Such a calculation is too simple to be realistic but it does suggest that some of the apparently large response of capital gains realizations to tax rate reductions must come from timing and from the conversion of other types of income into capital gains.

One natural criticism of a capital gains tax cut is that it is a regressive policy. Some have argued that, since revenues are not projected to fall, those who pay capital gains taxes will not receive a reduction in their tax burden. At best, this is true only in the most formal sense. If investors *choose* to pay more taxes, it is because doing so makes them better off. This presumes that they really are paying more taxes. If they do not actually pay more taxes, because the permanent increase in capital gains is smaller than predicted or because other taxes paid by these investors fall as a result of the increase in realizations, then the point is even stronger.

THE DEBT-EQUITY DISTINCTION AND CORPORATE PLANNING HORIZON'S

This committee has recently considered the potential problems associated with leveraged buyouts and, more generally, increasing corporate debt-equity ratios. Reducing the extent to which the U.S. tax system favors debt over equity is a sound objective to pursue, although it is doubtful that this one factor is the primary cause of recent changes in corporate management structure and financial policy. Reducing capital gains tax rates will narrow the gap between equity and debt, encouraging companies to issue equity rather than debt. However, in the short run, such a reduction in rates may actually encourage the conversions of equity into debt, for it will reduce the immediate capital gains tax cost of doing so.

Moreover, an increased differential in the tax rates on dividends and capital gains will encourage corporate retentions. Such a policy may be viewed as enhancing national saving by increasing corporate saving, but there is no clear evidence that household consumption actually goes down when corporations save more. It is entirely consistent with existing evidence that household saving goes down to offset increased corporate saving. The net impact of an induced increase in corporate saving, then, may be to deny funds to those firms that must go the capital market, including those fast-growing and venture capital enterprises that the policy is supposed to help.

Finally, let me offer a tentative opinion regarding the prospective three-year minimum holding period scheduled to apply beginning in 1995. A stated aim of the three-year minimum is to lengthen the planning horizon of managers by encouraging long-term commitments by investors. Such an objective may well be desirable, but reducing the rate on long-term gains could work in the opposite direction. One of the reasons often given for the supposed shortening of the planning horizons of U.S. companies is the recently heightened takeover threat that managers face, forcing them to produce results immediately and sacrifice potentially lucrative long-term projects and planning. A lower rate of capital gains tax, even if it applies only after a three-year holding period, will facilitate takeovers, even as it may encourage investors to invest for the longer term. I cannot predict which effect will be stronger.

CONCLUSIONS

I believe the proposed reduction in capital gains tax rates will reduce federal tax revenues. However, this question should not be the main focus of discussion. The recent preoccupation with revenue estimates has diverted attention from many critical issues regarding the effects of capital gains taxes. Despite recent budget pressures, it is inappropriate to judge tax measures solely by their revenue effects. Were this a particularly desirable policy in other respects, it might well be worth finding money elsewhere in the budget to pay for it. For the reasons stated above, however, I do not see that this standard is met.

[JOINT COMMITTEE PRINT]

TAX TREATMENT OF CAPITAL GAINS AND LOSSES

Scheduled for a Hearing

before the

SENATE COMMITTEE ON FINANCE

On March 14, 1989

Prepared by the Staff

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INTRODUCTION

The Senate Committee on Finance has scheduled a hearing on March 14, 1989, on the tax treatment of capital gains and losses and the President's budget proposal to reduce the tax rate on certain capital gains to a maximum rate of 15 percent.

This pamphlet,[1] prepared in connection with the hearing, provides a description of the present-law tax treatment of capital gains and losses, legislative background, the President's budget proposal, as well as a brief analysis of issues related to the President's proposal.

Prior Joint Committee on Taxation staff pamphlets [2] also provide a discussion of prior law tax treatment of capital gains and losses and related issues.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of Capital Gains and Losses* (JCS-7-89), March 11, 1989.

[2] See, Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Capital Income* (JCS-35-85), August 8, 1985, pp. 24-44, and Joint Committee on Taxation, *Taxation of Capital Gains and Losses* (JCS-52-83), November 1, 1983.

I. PRESENT LAW

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On disposition of a capital asset, long-term capital gain is presently taxed at the same rate as ordinary income. Long-term capital loss is deductible against capital gain, but not against ordinary income except to a limited extent. For depreciable property used in a trade or business and not held for sale to customers, and for certain other noncapital assets, net gain can be treated as capital gain, while net loss is an ordinary loss.

A complex set of statutory provisions attempts to limit the ability of taxpayers to recharacterize ordinary income assets as assets eligible for capital gain treatment, and also requires recharacterization of capital gain as ordinary income to the extent of certain prior deductions from ordinary income. In addition, certain judicial interpretations of the statutory provisions require gain or loss to be characterized as ordinary, rather than capital, in certain circumstances.

As a result of the changes made by the Tax Reform Act of 1986, taxing capital gains at the same rate as ordinary income, many of these rules now affect only the determination of the deductibility of capital losses.

The Tax Reform Act of 1986 provided that the maximum rate for capital gains would not exceed the maximum ordinary income rates specified in the Act. (See Code section 1(j).) The various rules relating to the recharacterization of gains as capital rather than ordinary were retained in the Code to facilitate the reinstatement of a capital gains rate differential if there is a future tax rate increase.[3]

A. Statutory Provisions

Capital gains

Long-term capital gain is defined as gain from the sale or exchange of a capital asset held for more than one year. Net long-term capital gain is the excess of long-term capital gains over long-term capital losses.

Capital losses

Capital losses of noncorporate taxpayers are generally deductible in full against capital gains.[4] In addition, such losses may be deducted against a maximum of $3,000 of ordinary income in each year. Capital losses in excess of these limitations may be carried over to future years indefinitely, but may not be carried back to prior years.

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[3] H. Rept. 99-841, p. II-106, Conference Report on H.R. 3838.

[4] However, section 165 generally denies individuals a deduction for losses not incurred in a trade or business unless such losses are incurred in a transaction entered into for profit or qualify as deductible casualty losses. *See also* section 267 (disallowance of deduction for certain losses from sale or exchange of property between related persons); section 1092 (limitation on current deductibility of losses in the case of straddles).

Capital assets

A "capital asset" generally means any property held by the taxpayer except certain specified classes. Capital assets generally do not include (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, or (5) certain U.S. publications.

Certain depreciable property, nondepreciable business property, and special assets (sec. 1231)

A special rule (sec. 1231) applies to gains and losses on the sale, exchange, or involuntary conversion of certain noncapital assets. Net gains from such assets (in excess of depreciation recapture) are treated as long-term capital gains but net losses are treated as ordinary losses. However, net gain from such property is recharacterized as ordinary income to the extent net losses from such property in the previous 5 years were treated as ordinary losses. The assets eligible for this treatment include depreciable property or land held for more than one year and used in a trade or business (if not includible in inventory and not held primarily for sale to customers in the ordinary course of business). Also included are certain special assets including interests in timber, coal, domestic iron ore, certain livestock and certain unharvested crops.

Patents

Under certain circumstances, the creator of a patented invention may transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset, whether or not the proceeds are contingent on the use or productivity of the patent (sec. 1235).

Regulated futures contracts

Under present law, unlike most assets (with respect to which no gain or loss is realized until a disposition) regulated futures contracts, foreign currency contracts, nonequity options and dealer equity options are "marked-to-market" as gain or loss accrues (sec. 1256). Forty percent of the gain or loss is short-term gain or loss and 60 percent of the gain or loss is long-term gain or loss. Prior to the Tax Reform Act of 1986, this resulted in a maximum tax rate of 32 percent. Individuals who have a net loss regarding such contracts may elect to carry it back three years against prior net gain regarding such contracts.

Losses on small business stock

An individual may deduct as an ordinary loss up to $50,000 ($100,000 in the case of a joint return) on the loss from the disposition of small business corporation stock (section 1244 stock) originally issued to the individual (or to a partnership having the individual as a partner), without regard to the $3,000 limit generally applicable to losses. A small business corporation is a corporation engaged in the active conduct of a trade or business whose equity capital does not exceed $1,000,000.

Certain foreign corporate stock

Special rules recharacterize as ordinary income a portion of gain on the sale or exchange of certain foreign corporate stock, to compensate for the deferral of U.S. tax on corporate earnings and profits accumulated abroad (sec. 1248).

Collapsible property

The distinction between capital gains and ordinary income has led to numerous taxpayer attempts to realize the value of an anticipated future ordinary income stream through the sale of a "capital" asset, such as stock in a corporation, or an interest in a partnership, that holds the income-producing asset.

Present law contains statutory rules intended to prevent such use of partnerships and corporations to convert what otherwise would be ordinary income into capital gains from the disposition of stock or a partnership interest. These provisions (secs. 341 and 751) known as the "collapsible" corporation and "collapsible" partnership provisions, are among the most complex provisions of the Internal Revenue Code and have been criticized by some for apparent inconsistencies in application and for limited effectiveness in some circumstances.

Similarly, certain partnership rules relating to basis allocations (secs. 732(c) and 755) attempt to prevent conversion of ordinary income to capital gain by preventing allocations of basis from capital assets to ordinary income assets in certain partnership transactions. These rules have also been criticized by some as having limited effectiveness in certain situations.

Recapture provisions

Depreciation recapture rules recharacterize as ordinary income a portion of gain upon dispositions of depreciable property. These rules vary with respect to the type of depreciable property. Under ACRS, for personal property, previously allowed depreciation (up to the amount of realized gain) is generally recaptured as ordinary income. In the case of real property using the straight-line method of depreciation (the only method generally permitted for real property placed in service under present law ACRS), there is no depreciation recapture upon disposition if the asset is held more than one year. For real property to which the present law ACRS does not apply, generally, the excess of depreciation deductions over the straight-line method is recaptured as ordinary income. Special rules apply to certain non-residential property and to certain low-income housing.

Similar recapture rules apply to dispositions of oil, gas, geothermal or other mineral property. These rules require ordinary income recapture (up to the amount of realized gain) of previously deducted intangible drilling and development costs, mining expenses, and depletion.

The recapture rules require the recognition of ordinary income in some situations that are otherwise tax-free or tax-deferred. For example, although recognition of gain on an installment sale is otherwise deferred, recaptured ordinary income with respect to depreciated real or personal property is recognized in the year of the sale.

Recapture is imputed to a partner who sells a partnership interest if recapture would have been imposed upon the disposition by the partnership of the recapture property. Except in the case of certain previously deducted depletion, intangible drilling and development and mining exploration costs, there is no comparable imputation to a shareholder of an S corporation who sells his or her stock.

Realization events

In general, property appreciation is not taxed until the property is disposed of in a taxable transaction. There are certain exceptions to this rule. For example, the present law treatment of regulated futures contracts and certain other items which are "marked to market" as gain or loss accrues even though there has been no disposition of the asset.

Nonrecognition events

Under various nonrecognition provisions, realized gains and losses in certain transactions are deferred for tax purposes. Examples of such nonrecognition transactions include certain corporate reorganizations, certain like-kind exchanges or property, involuntary conversions followed by an acquisition of replacement property, and the sale of a principal residence within two years of the acquisition of a new principal residence. Generally, nonrecognition treatment defers gain or loss for tax purposes by providing a carryover basis from the old holder to the new holder or a substitution of basis from the old property to the new property.

Certain exemptions

Present law effectively forgives income tax on accrued appreciation on the occurrence of certain events. For example:

Basis step-up at death.—At death, income tax on unrealized capital gains on an individual taxpayer's assets is forgiven, due to the step-up in basis such assets receive.[5]

Sale of principal residence.—$125,000 of gain on the sale of a principal residence by a taxpayer over age 55 is exempt from tax if, during the 5-year period ending with the date of the sale, the property was owned and used as the taxpayer's principal residence for at least an aggregate of 3 years.

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[5] Such appreciation might give rise to Federal estate and gift tax. In many instances, however, opportunities for deferral and the rate structure under the Federal estate and gift tax may result in significantly less tax than would be imposed under the income tax. The value of stock or other assets held at death would be included in the decedent's gross estate and, if not passing to a surviving spouse or to charity, the decedent's taxable estate as well.

The extent to which such inclusion gives rise to Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax depends on the value of the decedent's taxable transfers. The Federal estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent (50 percent for decendents dying after 1992) on taxable transfers over $3 million. A unified credit in effect exempts the first $600,000 from estate and gift tax. The graduated rates and unified credit are phased out for estates in excess of $10 million.

B. Statutory Interpretations

The statutory provisions described above have led to numerous disputes about the characterization of gain or loss as capital or ordinary. Literally hundreds of cases have been litigated involving capital gains issues; and the varying results of the cases can encourage taxpayers to take aggresive positions on tax returns. The issues that have been litigated and the principles asserted in particular cases include the following:

Property held primarily for sale to customers

Inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business are excluded from the definition of a capital asset. The object of this exclusion is to preclude capital gains treatment for receipts obtained in the routine conduct of the taxpayer's enterprises.

A host of cases have been litigated over whether gain received by the taxpayer was attributable to the sale of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. The majority of these cases have involved real estate sales, and the sale of equipment held for rental (or for rental and then sale). In both instances, the litigation generally revolves around the question of the "primary" purpose for which the property was held. *Cf. Malat v. Riddell*, 383 U.S. 569 (1966). The resolution of this question, in turn, has generated an intricate web of subordinate rules and exceptions relating to (1) the existence of business (ordinary income) and investment (capital gain) purposes and (2) the acquisition of property for one purpose and its disposition for another purpose. Factual issues include the extent to which the taxpayer advertised the property, the frequency of sales, and whether unusual circumstances led to the sale. *See, e.g., The Municipal Bond Corporation v. Commissioner*, 341 F.2d 683 (8th Cir. 1965), *on remand*, 46 T.C. 219 (1966). In many situations, the taxpayer may have a considerable degree of flexibility in adopting those advertising or sales practices that are the most likely to support the desired result.

Sale or exchange treatment

Many cases have involved the issue whether a transfer is a sale or exchange, thus qualifying for capital gains treatment, or a transfer more properly characterized as a lease or other transfer producing ordinary income. This issue arises, for example, where the transferor has the right to receive contingent payments based on future sales or profits, or retains certain elements of control over the property. *See, e.g., Nassau Suffolk Lumber & Supply Corp. v. Commissioner*, 53 T.C. 280 (1969) (Acq. 1970-2 C.B. xx). Statutory provisions have been enacted to deal with certain types of transfers (*e.g.,* sec. 1235, providing capital gain treatment for certain transfers of patents for future periodic or contingent payments; sec.1253, providing ordinary income treatment when certain rights to control the use of specified intangibles are retained). However, where these provisions do not apply, the issue remains.

Another issue that arises is whether there is a difference in sale or exchange characterization between the termination or expiration of certain instruments or contract rights and the assignment of such rights to a third party prior to expiration.[6] There is some authority that in certain situations if an instrument or right is held to maturity or expiration, the expiration is not a sale or exchange and the resulting gain or loss is ordinary; but if the instrument or right is sold prior to expiration, gain or loss on the sale is capital. *See, e.g., International Flavors and Fragrances v. Commissioner*, T.C. Memo 1977–58, 36 T.C.M. 260 (1977). Various statutory provisions attempt to specify the outcome in the case of particular instruments or rights (*e.g.*, sec. 988, generally requiring ordinary rather than capital treatment for certain foreign currency related transactions; sec. 1271 and related provisions, dealing with certain debt instruments).

Holding period

Numerous cases have involved the issue whether the taxpayer satisfied the required holding period for capital gains treatment. Taxpayers may utilize various arrangements in attempts to shift ownership of assets prior to the expiration of the required holding period while still appearing to meet the holding period requirement. For example, taxpayers may attempt to transfer short-term assets in a tax-free transaction to another entity controlled by the taxpayer that has been held for the required period of time, and then dispose of that entity under circumstances where the various collapsibility or recapture rules may be vulnerable or inadequate.

Taxpayers may also attempt to enter transactions that effectively shift the risk of gain or loss to another prior to expiration of the holding period, but that do not in form provide for a sale until after the holding period expires.

Allocation of gain to capital assets

Numerous cases have involved the proper allocation of purchase price among assets. When a taxpayer sells a combination of assets some of which are eligible for capital gains treatment and some of which are not, it is necessary to allocate the purchase price and the taxpayer's resulting gain among the assets. *Williams V. McGowan*, 152 F. 2d 570 (2d Cir. 1945). Under the prior law differential between capital gains and ordinary income, the seller of property had an incentive to allocate more of his gain to capital assets. As one example, under the prior law differential for capital gains, on the sale of a building and land under circumstances where there would be recapture of accelerated depreciation on the building, the seller had an incentive to allocate more of the gain to the land, thus reducing the potential recapture. Because the building is depreciable and the land is not, the buyer has an incentive on the contrary to allocate more of the price to the building. In some cases, this tension between the parties might limit the degree to which the government would be whipsawed by parties taking inconsistent positions. In general, if the parties did specify an allocation in their contract with appropriate regard to value, they are bound by it for tax purposes; and if they have adverse tax interests the courts and the Internal Revenue Service will generally accept the allocation. *See, e.g., Ullman v. Commissioner*, 264 F. 2d 305 (2d Cir. 1959); *Commissioner v. Danielson*, 378 F. 2d 771 (3d Cir.) *cert. denied* 389 U.S. 858 (1967). However, it is not clear whether taxpayers will always specify an allocation in a contract or take consistent positions.

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[6] *See also* discussion of "Other capital asset definitional issues," *infra*.

Another example of the same issue arises on the sale of a business, where the seller would have an incentive to allocate more of the price to goodwill or other assets eligible for capital gains treatment, while the buyer would prefer to allocate more of the price to depreciable assets. Under prior law, many intangible assets depreciable by the buyer were eligible for capital gains treatment by the seller, thus eliminating any tension between the parties.

The Tax Reform Act of 1986 added section 1060 to the Code. This section generally applies to sales of trade or business assets. It specifies a residual method of allocating price to nondepreciable goodwill and going concern value, generally adopting the method specified in Treasury Regulations dealing with certain sales of corporate stock that are treated as sales of the underlying assets (Prop. and Temp. Reg. sec. 1.338(b)-2T). It also authorizes the Internal Revenue Service to require the parties to report their respective allocations of purchase price, thus assisting the Internal Revenue Service in identifying inconsistent positions for audit. Some commentators have observed that the section does not strictly require consistent allocations and it is unclear to what extent the government would still be exposed to whipsaw due to inconsistent positions taken by the parties during periods of a capital gains rate differential.

Corn Products doctrine

In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), the Supreme Court addressed a taxpayer claim that gain on the disposition of corn futures was capital gain. The taxpayer was a manufacturer of products made from grain corn and had acquired the corn futures to assure the needed supply of corn at a fixed price. The Supreme Court held that the disposition of the futures produced ordinary income, even though the futures were not literally inventory or other property specifically excluded by statute from the definition of a capital asset. The Court held that gain on this type of hedging transaction was ordinary income, and stated that Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss. Numerous subsequent lower court decisions interpreted the *Corn Products* decision to mean that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset. In 1975, the Internal Revenue Service stated that if a taxpayer acquired and held property with a "predominant" business (as opposed to investment) purpose, gain or loss on disposition would be ordinary; conversely, a "predominant" investment purpose would cause gain or loss to be capital. (Rev. Rul. 75-13, 1975-1 C.B. 67.) Later, following several Tax Court decisions,[7] the Internal Revenue Service took the position that even a "predominant" business motive cannot preclude capital gain or loss treatment, as long as there was a "substantial" investment motive for acquiring or holding the property. (Rev. Rul. 78-94, 1978-1 C.B. 58). Of course, it is to the taxpayer's advantage to have gains characterized as capital, and losses as ordinary.

In *Arkansas Best Corp. v. Commissioner*, ——U.S. —— (108 S. Ct. 971) (1988), the Supreme Court rejected a taxpayer claim for ordinary loss treatment on the sale of stock of a bank that had been 65 percent owned by the taxpayer's holding company. The Supreme Court stated that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of the Code. There is considerable uncertainty about the scope of the *Arkansas Best* decision and its impact on lower court decisions and Internal Revenue Service positions interpreting *Corn Products*.

Arrowsmith doctrine

In *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), the Supreme Court held that amounts paid by former corporate shareholders (as the transferees of corporate assets received in a prior year corporate liquidation) to satisfy liabilities of the liquidated corporation were capital, rather than ordinary losses. The Court related the payments to the earlier receipt (at capital gains rates) of corporate assets in the liquidation. Pursuant to *Arrowsmith*, the characterization of a transaction in one year may depend upon its relationship to another transaction in a prior year.

Other capital asset definitional issues

A number of cases have addressed the question of the extent to which a taxpayer may obtain capital rather than ordinary treatment by assigning various contract rights that, if held to maturity, would have produced ordinary income. In certain circumstances, this ability has been limited by a court's conclusion that the asset assigned is not a capital asset but rather a substitute for ordinary income. *See, e.g., Commissioner v. Ferrer*, 304 F. 2d 125 (2d Cir. 1962); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958). On the other hand, in many situations the assignment of all rights to a lease or to a business interest that would produce ordinary income in the future can be treated as capital gain.

Tax benefit rule

The Internal Revenue Service has occasionally asserted the "tax benefit rule" in attempts to recharacterize as ordinary income a portion of the gain from the disposition of property otherwise entitled to capital gain treatment. The amount to be recharacterized reflects the extent to which the basis of such property was reduced by deductions taken from ordinary income, to which no specific statutory recapture provision applies on disposition of the property. For example, in *First National Bank of Lawrence County v. Commissioner,* 16 T.C. 147 (1951), the Internal Revenue Service successfully asserted that net proceeds received on the retirement of certain bonds that had previously been written off by a bank against ordinary income as worthless were taxable as ordinary income rather than as capital gain.

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[7] *W. W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *aff'd on other grounds*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977); *Bell Fibre Products Corp. v. Commissioner*, 36 T.C.M. (CCH) 182 (1977). *Compare Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct.Cl. 1975), *cert. denied*, 429 U.S. 82[illegible] (1976).

The scope of the tax benefit rule is uncertain [8] and the Internal Revenue Service does not contend that all items deducted from ordinary income are automatically subject to recapture on the sale of property otherwise eligible for capital gains treatment. For example, the Internal Revenue Service has ruled under section 174 that deductions previously taken for research and experimental expenditures under that section are not recaptured on disposition of the developed property.[9]

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[8] See *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983), for Supreme Court discussion of the rule.

[9] Rev. Rul. 85-186, 1985-2 C.B. 84. Prior to the issuance of this ruling, the Internal Revenue Service had taken a different position and indicated in a revenue ruling and in a technical advice memorandum that it might assert tax benefit rule recapture of research and experimental deductions taken under section 174 of the Code on the disposition of patents or technology otherwise eligible for capital gains treatment under the special rules applicable to patents or under other provisions (Rev. Rul. 72-528, 1972-2 C.B. 481; TAM 8409009 (1983)).

II. LEGISLATIVE BACKGROUND

Reduced tax rate for capital gains

Noncorporate capital gains were taxable at reduced rates from 1921 through 1987.

The Revenue Act of 1921 provided for a maximum 12.5 percent tax on gain on property held for profit or investment for more than 2 years (excluding inventory or property held for personal use). Because of the relatively low tax rates on ordinary income during the 1920's and 1930's, this provision benefited only higher bracket taxpayers.

The system of capital gains taxation in effect prior to the Tax Reform Act of 1986 dated largely from the Revenue Act of 1942. The 1942 Act provided for a 50 percent exclusion for noncorporate capital gains or losses on property held for more than 6 months. The Act also included alternative ceiling rates on capital gains taxes for noncorporate and corporate taxpayers. The basic structure of the 1942 Act was retained under the Internal Revenue Code of 1954.

The Revenue Act of 1978 increased the exclusion for noncorporate long-term capital gains from 50 to 60 percent. Together with concurrent changes in the noncorporate minimum tax, this had the effect of reducing the highest effective rate on noncorporate capital gains from approximately 49 percent [10] to 28 percent. The reduction in the maximum individual rate from 70 to 50 percent under the Economic Recovery Act of 1981 (ERTA) reduced the maximum effective capital gains rate from 28 percent to 20 percent.

The Tax Reform Act of 1986 repealed the provisions granting reduced rates for capital gains, fully effective beginning in 1988.

Indexing

In connection with the Revenue Act of 1978, the House passed a provision (the "House bill") to index the basis of certain assets for purposes of determining gain or loss upon a taxable sale; however the proposal did not become law. Under the House bill, the assets generally eligible for indexing were common stock, tangible personal property and real property, provided such assets were either capital assets or assets used in a trade or business and were held for more than one year.

No indexing was proposed for debt instruments. Indexing debt was viewed as producing complex adjustments that would not produce additional revenues where both the borrower and the lender have the same marginal tax rate. The House Committee report (apparently still addressing the situation in which a borrower and a lender have the same marginal rate) suggested that to the extent inflation is anticipated correctly and interest rates are free to rise, interest rates would tend to rise to a rate that would compensate for inflation on an after-tax basis.

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[10] The 49-percent rate resulted in certain cases where the taxpayer was subject to the individual "add-on" minimum tax and the maximum tax "earned income" limitation also applied.

The House bill contained numerous exceptions and other provisions intended to deal with an array of issues. These issues included the differentiation of common stock eligible for indexing from preferred stock (considered more like non-indexable debt); possible abuses such as incorporation of non-indexed assets to obtain indexing with respect to stock; problems regarding the appropriate treatment of interests in different types of flow-through entities (such as regulated investment companies, real estate investment trusts, partnerships and subchapter S corporations); and concerns related to application of the short sale and collapsible corporation provisions of existing law.

A proposal similar to the 1978 House bill passed the Senate in 1982 (as a floor amendment to the Tax Equity and Fiscal Responsibility Act of 1982), but was not enacted.

Holding period

Under the Revenue Act of 1921, the alternative maximum rate for capital gains applied to property held for more than 2 years. Since that time, Congress has, on several occasions, adjusted the holding period required for reduced capital gains taxation.

The Revenue Act of 1934 provided for exclusion of varying percentages of capital gains and losses depending upon the period for which an asset was held. Under that Act, 20 percent of capital gains was excludible if an asset was held for 1 to 2 years, 40 percent if an asset was held for 2 to 5 years, and 60 percent if the asset was held for between 5 and 10 years. Where an asset had been held for more than 10 years, 70 percent of capital gains was excluded.

The Revenue Act of 1938 provided for two classes of long-term capital gains. For assets held for 18 months to 2 years, a 33-percent exclusion was allowed. Where assets were held for more than 2 years, a 50-percent exclusion was provided. No exclusion was allowed for assets held for 18 months or less. The 1938 Act also provided alternative ceiling rates applicable to the same holding periods as the capital gains exclusions.

In the Revenue Act of 1942, Congress eliminated the intermediate holding period for capital gains purposes. The 1942 Act provided for two categories of capital assets: assets held for more than 6 months (long-term capital assets), for which a 50-percent exclusion was allowed; and assets held for 6 months or less (short-term capital assets) for which no exclusion was provided. The alternative tax rates on individual and corporate net capital gains (i.e., the excess of net long-term capital gains over short-term capital losses) were based upon the same 6-month holding period.

A 6-month holding period for long-term capital gains treatment remained in effect from 1942 through 1976. The Tax Reform Act of 1976 increased the holding period to 9 months for 1977 and one year for 1978 and all subsequent years. The Deficit Reduction Act of 1984 reduced the holding period to 6 months for property acquired after June 22, 1984 and before 1988.

Treatment of gain and loss on depreciable assets and land used in trade or business

Depreciable property used in a trade or business was excluded from the definition of a capital asset by the Revenue Act of 1938, principally because of the limitation on deductibility of losses imposed by the Revenue Act of 1934. This step was motivated in part by the desire to remove possible tax deterrents to the replacement of antiquated or obsolete assets such as equipment, where depreciation would be fully deductible against ordinary income if the asset were retained, but loss would be subject to the capital loss limitations if the asset were sold.

The availability of capital gain treatment for gains from sales of depreciable assets stems from the implementation of excess profits taxes during World War II. Many depreciable assets, including manufacturing plants and transportation equipment, had appreciated substantially in value when they became subject to condemnation or requisition for military use. Congress determined that it was unfair to tax the entire appreciation at the high rates applicable to wartime profits. Accordingly, in the Revenue Act of 1942, gains from wartime involuntary conversions were taxed as capital gains. The provision was extended to voluntary dispositions of assets since it was not practical to distinguish condemnations and involuntary dispositions from sales forced upon taxpayers by the implicit threat of condemnation or wartime shortages and restrictions.

The Revenue Act of 1938 did not exclude land used in a trade or business from the capital asset definition. Since basis would have to be allocated between land and other property for purposes of depreciation in any event, the differing treatment of land used in a trade or business and depreciable property used in a trade or business was not viewed as creating serious allocation difficulties.

However, in the Revenue Act of 1942, Congress excluded land used in a trade or business from the definition of a capital asset and extended to such property the same special capital gain/ordinary loss treatment afforded to depreciable trade or business property.

Noncorporate capital losses

In the early years of the income tax, losses from investments not connected with a trade or business were not deductible even against gains from similar transactions. This rule was changed in 1916 to allow deductions for transactions entered into for profit (but only to the extent of gains from similar transactions). The rule was further adjusted by the Revenue Act of 1918.

The Revenue Act of 1921 provided that net capital losses were deductible in full against capital gains or ordinary income. Because capital gains at this time were taxable at a maximum 12.5-percent rate, but capital losses could be used to offset income taxable at higher rates, this rule resulted in substantial revenue loss. Accordingly, the rule was amended by the Revenue Act of 1924 to limit the tax benefit from capital losses to 12.5 percent of the amount of such losses. The 1924 Act also repealed the previously existing carryforward for excess capital losses.

Under the Revenue Act of 1934, the percentage exclusion for net capital gains was made dependent upon the length of time for which the property was held. In conjunction with this change, the Act allowed equivalent percentages of capital losses to be deducted against capital gains and, in the event of any excess, against $2,000 of ordinary income. The $2,000 limit on the amount of ordinary income against which capital losses could be deducted was motivated by the fact that some very wealthy investors had been able to eliminate all their income tax liability by deducting losses incurred in the stock market crash against ordinary income.

Under the Revenue Act of 1942, capital losses could offset up to $1,000 of ordinary income with a carryforward of unused losses. The Tax Reform Act of 1976 increased this amount to $3,000. Between 1970 and 1986, only one-half of the net long-term loss could be carried forward.

In 1958, individuals were allowed to deduct up to $25,000 ($50,000 on a joint return) of loss from the disposition of stock in a small business corporation as an ordinary loss. These limitations were doubled in 1978.

III. PRESIDENT'S BUDGET PROPOSAL

The President's budget proposal[11] would allow individuals an exclusion of 45 percent of the gain realized upon the disposition of qualified capital assets. Further, the maximum tax rate applicable to any gains on qualified assets would be 15 percent. The exclusion would not be a preference for purposes of the alternative minimum tax. Taxpayers with gain on qualified assets would be able to exclude 100 percent of the gain, if the taxpayer's adjusted gross income (calculated including 55 percent of the gain) is less than $20,000 ($10,000 for single taxpayers or married taxpayers filing separately). Taxpayers with an adjusted gross income less than $20,000 but who are subject to the alternative minimum tax would not be eligible for the 100-percent exclusion.

Qualified capital assets generally would be capital assets as defined under present law other than depreciable, depletable, and amortizable property used in the taxpayer's trade or business. Thus land, but not buildings, used in the taxpayer's trade or business, would qualify for capital gains treatment. Collectibles would not be treated as qualified assets. The special section 1231 assets, *i.e.*, certain interests in timber, coal, iron ore, livestock, and unharvested crops, would not be treated as qualified assets.

In addition, to be a qualified asset, the taxpayer must satisfy a holding period requirement. The asset must have been held for more than 12 months if the asset is sold in 1989, 1990, 1991, or 1992; for more than 24 months if the asset is sold in 1993 or 1994; and for more than 36 months if the asset is sold in any year after 1994.

The proposal would be effective for assets sold on or after July 1, 1989.

Revenue Effects

The staff of the Joint Committee on Taxation has estimated the following revenue effects of the Administration's proposal for fiscal years 1989 through 1994.[12] To make this estimate it was necessary to make several assumptions in regards to parts of the Administration's proposal for which complete details were not provided. The estimate assumes the enactment of very strong rules to prevent gains on collectibles and depreciable property from qualifying for the exclusion. The estimate assumes very limited income shifting between high income taxpayers and their dependents whose adjusted gross income is less than $10,000. The estimate assumes that the taxpayer is permitted to deduct 50 percent of net long-term losses and that losses on qualified assets must be netted against gains on qualified assets, while losses on non-qualified assets must be netted separately against gains on non-qualified assets.

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[11] See, The White House, *Building a Better America*, February 9, 1989, pp. 31–33; and the Treasury Department, General *Explanations of the President's Budget Proposals Affecting Receipts*, February 1989, pp. 1–16.

[12] The Treasury Department's estimate of the revenue effects for the same period is a revenue gain of $0.7 billion in fiscal 1989, a revenue gain of $4.8 billion in fiscal 1990, a revenue gain of $4.9 billion in fiscal 1991, a revenue gain of $3.5 billion in fiscal 1992, a revenue gain of $2.2 billion in fiscal 1993, and a revenue loss of $6.8 billion in fiscal 1994, for a six-year total gain of $9.3 billion.

Table 1.—Revenue Estimates of the Administration's Capital Gains Proposal, Fiscal Years 1989-1994

[In billions of dollars]

Fiscal year	1989	1990	1991	1992	1993	1994	1989–94
Revenue effect	0.7	3.3	−4.0	−6.4	−6.9	−10.9	−24.2

Source: Joint Committee on Taxation staff.

IV. ANALYSIS OF ISSUES

A. Issues Relating to a Reduced Tax on Capital Gains

1. Arguments for reduced tax on capital gains

Lock-in.—Many argue that higher tax rates discourage sales of assets. This lock-in effect is exacerbated by the rules which allow a step-up in basis at death and exempt certain sales of homes. The legislative history suggests that this lock-in effect was an important consideration in Congress' decision to lower capital gains taxes in 1978. Preferential tax rates impose a smaller tax on redirecting monies from older investments to projects with better prospects, in that way contributing to a more efficient allocation of capital.

Incentives for equity investments.—A second argument for preferential capital gains tax rates is that they encourage investors to buy corporate stock, and especially to provide venture capital for new companies, stimulating investment in productive business activities. This argument was important in the 1978 debate over capital gains taxes, and there has been a large growth in the availability of venture capital since 1978. Proponents argue that the preference provides an incentive for investment and capital formation, with particular mention of venture capital and high technology projects.

Others argue that the capital gains preference may be an inefficient mechanism to promote the desired capital formation. They argue that a preferential capital gains tax rate is not targeted toward any particular type of equity investment although promotion of high technology venture capital is apparently a goal. Furthermore, a broad capital gains preference affords capital gains treatment to non-equity investments such as gains on municipal bonds and certain other financial instruments.

To the extent that potential sources of venture capital or other equity investment, or secondary purchasers of corporate stock, are tax-exempt or partially tax-exempt (for example, pension funds and certain insurance companies and foreign investors), a tax preference could have a small incentive effect on investment. Since 1978, tax-exempt entities (pension funds and non-profit institutions) have constituted the fastest growing source of new venture capital funds.[13] On the other hand, proponents argue that capital gains treatment for venture capitalists who are taxable has importance. They argue that this is particularly acute for the entrepreneur who often contributes more in time and effort than in capital.

Opponents of a capital gains preference argue that creating a preference for capital gains could encourage the growth of debt and the reduction of equity throughout the economy. When debt is used in a share repurchase program or leveraged buyout transaction the taxpayers who hold the original equity securities must realize any gain that they might have. A lower tax rate on gains could make holders of equity more likely to tender their shares in a leveraged buyout transaction or share repurchase program.[14]

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[13] *See* James M. Poterba, "Venture Capital and Capital Gains Taxation," paper presented at 1988 NBER Conference on Tax Policy and the Economy, Washington, November 15, 1988.

Competitiveness.—Related to the argument that preferential capital gains tax rates encourage investment is the argument that a lower capital gains tax rate will improve the international competitive position of the United States. Proponents of a reduction in capital gain tax rates observe that many of our major trading partners have lower marginal tax rates on the realization of capital gains than does the United States. For example, prior to this year, all gains on stocks, bonds, and unit trusts were exempt from tax in Japan. The recent Japanese tax reform would impose a tax at the taxpayer's discretion of either one percent of the gross proceeds or 20 percent of the gain, a rate still below the maximum U.S. rate. In Germany all long-term gains are exempt from tax.

Others point out that the issue of the effect of capital gains taxes on international competitiveness is really one of the cost of capital of domestic firms compared to that of their competitors. Corporate income taxes, individual income taxes on interest and dividends, net wealth taxes,[15] as well as taxes on capital gains, all may affect the cost of capital. Opponents of a capital gains preference argue that the fact that marginal tax rates on capital gains are higher in the United States than in other countries does not imply automatically that American firms are at a competitive disadvantage. Moreover, because of the ability to defer gains, to receive step-up at death, and because of substantial holding of corporate equity by tax-exempt institutions, the effective tax rate on gains, which helps determine the cost of capital, may be substantially below the statutory rate. For example, one recent study calculated that prior to 1987 the effective marginal tax rate on capital gains, including State taxes, was less than 6 percent.[16]

On the other hand, proponents of a capital gains tax reduction contend that any reduction in a tax on capital may reduce the cost of capital.

Bunching.—Because capital gain is generally not taxed until a disposition, taxpayers can face large jumps in taxable income when the gain is realized. With graduated tax rates, such bunching could lead to a higher tax burden than if the gain were taxed as it accrued. If the benefit of deferral is not enough to compensate for the extra tax in some of those cases, then the additional benefit of a preferential tax rate helps to achieve parity (although its availability is not limited to such cases).

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[14] Jane Gravelle, "Tax Aspects of Leveraged Buyouts," CRS Report to Congress, 89-142 RCO, March 2, 1989.

[15] While the United States does not impose on annual tax on an individual's net wealth, several of our trading partners do, for example, West Germany, the Netherlands, Spain, and Switzerland. *See* OECD, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*, Paris, 1988.

[16] Don Fullerton, "The Indexation of Interest, Depreciation, and Capital Gains and Tax Reform in the United States," *Journal of Public Economics*, 32, February 1987, pp. 25-51.

Some analysts have argued that the flattened marginal tax rate schedule of present law diminishes the amount of bunching and so, presumably, reduces the need for a preferential tax rate as a remedy for it. These analysts have stated that the most significant bunching problems under present law would now befall those taxpayers in the 15 percent marginal tax bracket whose gains could push them into the 28 percent bracket. However, they point out that relatively few taxpayers who realize gains are in these circumstances.

Inflation.—Another argument for preferential tax treatment of capital gain is that part of the gain represents the effects of inflation and does not constitute real income. This argument was also important in 1978. Proponents observe that the preference may provide to taxpayers some rough compensation for inflation.

Others claim that a preferential tax rate is a very crude adjustment for inflation. For example, since 1978 the price level approximately has doubled. Thus, an asset purchased in 1978 for $1,000 and sold today for $2,000 would have a purely inflationary gain. Even with a preferential rate, this gain would be taxed. On the other hand, for an individual who purchased an asset in 1986 for $1,000 and sold it today for $2,000, a reduction in the tax rate from 28 percent to 15 percent would more than offset the effects of inflation over the past three years. A preferential rate also does not account for the impact of inflation on debt financed assets, where inflation reduces the cost of repaying the debt.

Double taxation of corporate earnings.—Theorists have suggested that capital gains treatment on a disposition of corporate stock might be viewed as ameliorating the double taxation of corporate earnings. The first step of double taxation occurs at the corporate level; the second step occurs at the shareholder level as dividends are paid or as shares which have presumably increased in value by retained earnings are sold. However, other theorists have argued that preferential capital gains treatment is a very inexact means of accomplishing any such benefit. Among other things, the capital gains holding period requirement is unrelated to earnings. Also, any relief that a capital gains preference provides from the burden of double taxation applies only to retained corporate earnings. Distributed earnings would be still generally subject to double taxation.

2. Arguments against reduced tax on capital gains

Measurement of income.—Opponents of reduced tax on capital gains argue that appreciating assets already enjoy a tax benefit from the deferral of tax on accrued appreciation until the asset is sold, which benefit reduces in whole or in part any bunching or inflationary effects. In addition, if capital assets are debt-financed, inflation will reduce the real cost of borrowing to the extent interest rates do not rise to compensate for the reduced value of principal repayments and interest is deductible. Thus, debt financing may further tend to offset any adverse impact of inflation. Some opponents of the preference have contended that a direct basis adjustment by indexing for inflation would be more accurate and would reduce uncertainty regarding the eventual effective rate of tax on investments that might impair capital formation.[17]

On the other hand, proponents of a preference for capital gains contend that the benefit of deferral is insufficient to make up for more than very modest inflation. Moreover, they argue that indexing may be viewed as too complex to implement.

Neutrality.—To the extent that preferential rates may encourage investments in stock, opponents have argued that the preference tilts investment decisions toward assets that offer a return in the form of asset appreciation rather than current income such as dividends or interest. Furthermore, because the individual capital gains preference is accomplished by a deduction from income, it provides a greater benefit to high-income than to middle- or low-income taxpayers. On the other hand, it is argued that neutrality is not an appropriate goal because risky investments that produce a high proportion of their income in the form of capital gains may provide a social benefit not adequately recognized by investors in the marketplace.

Reduction of "conversion" opportunities.—Opponents of the preferential capital gains rate contend that it not only provides a reduced tax rate on gains from the preferred assets but also encourages taxpayers to enter transactions designed to convert other, ordinary, income to capital gains.

Conversion can also occur through debt-financing the cost of assets eligible for capital gains rates. For example, if a taxpayer borrows $100 at 10 percent annual interest to acquire a capital asset that is sold for $110 a year later, and repays the borrowing with sales proceeds, the taxpayer has an interest deduction of $10 that can reduce ordinary income[18] and a capital gain of $10 subject to preferential rates. The taxpayer thus has a net after-tax positive cash flow even though on a pre-tax basis the transaction was not profitable.

On the other hand, it is argued that such "conversion" opportunities are simply an additional tax incentive for types of investments the capital gains preference is intended to encourage.

Simplification and consistent treatment of taxpayers.—Opponents of the preferential capital gains rate point out that the application of different tax rates to different sources of income inevitably creates disputes over which assets are entitled to the preferential rate and encourages taxpayers to mischaracterize their income as derived from the preferred source. Litigation involving holding period, sale or exchange treatment, asset allocation, and many other issues has been extensive. A significant body of law, based both in the tax code and in judicial rules, has developed in response to conflicting taxpayer and Internal Revenue Service positions in particular cases. Its principles are complicated in concept and application, typically requiring careful scrutiny of the facts in each case and leaving opportunities for taxpayers to take aggressive tax return positions. It has been argued that the results derived in particular cases lack even rough consistency, notwithstanding the substantial resources consumed in this process by taxpayers and the Internal Revenue Service. Elimination of the preferential rates on capital gains has obviated the incentive for many such disputes. It has also obviated the need for such complex provisions as the collapsible corporation and collapsible partnership rules, which have been criticized for apparent inconsistencies in application, and certain aspects of the varying recapture provisions for different types of assets.

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[17] A more detailed discussion of issues relating to indexation of capital gains is below (D. "Indexing").

[18] Even if an interest deduction is subject to present law investment interest limitations, it can be offset against investment income that is ordinary income.

On the other hand, it is argued that so long as a limitation on deductions of capital or investment loss is retained, some areas of uncertainty and dispute continue to exist (for example, whether property was held primarily for sale to customers in the ordinary course of business, and the application of the *Corn Products* and related doctrines). Since (as discussed further below) limitations on the deductibility of capital or investment losses may be desirable to limit the selective realization of losses without realization of gains, the amount of simplification and consistency that has occurred as a result of eliminating the preference for long term capital gains has been limited somewhat.

B. Issues Specific to the Administration's Proposal

1. Holding period

Some argue that taxpayers do not plan their investments with sufficiently long time horizons. They argue that because some taxpayers realize their gains after holding the investment for short periods, managers of enterprises plan their enterprise's investment with a view to the short run, foresaking profitable long term investments. Others argue that there is no evidence that managers ignore potentially profitable long term investments at the expense of short term investments and that there is no evidence of a causal link between stockholder holding period and management behavior.

Establishing a holding period requirement of 36 months to qualify for preferential capital gain treatment would create incentives for some of those taxpayers who would otherwise realize their gains in less than 36 months to defer some of those gains until they had been held for at least 36 months. On the other hand, taxpayers who have losses on stock held between 12 and 36 months will have an incentive to realize their losses before the 36 month period expires, while under present law the tax treatment of losses does not change at that point. The holding period requirement would not be expected to have any effect on the timing of the realization of gains which taxpayers would have realized after 36 months in the absence of the holding period requirement.

Lengthening the holding period should, by itself, increase taxpayers' average holding periods for all assets in their portfolios. However, taxpayers' average holding periods probably are affected by more than the holding period requirement. If a reduction in the tax rate on capital gains induces taxpayers to realize gains in their portfolios more frequently and to realize gains which they otherwise would have held, unrealized, until death, then taxpayers' average holding periods for all assets in their portfolios may decline.

Consequently, while the Administration's proposal may cause fewer taxpayers to realize gains within 36 months, it may also cause the average holding period to fall.

2. Capital losses

Deductibility against ordinary income.—The present limits on the deductibility of capital losses against ordinary income are intended to address problems that arise from the high degree of taxpayer discretion over when to sell certain types of assets. If capital losses were fully deductible against ordinary income, as was the case between 1921 and 1934, a taxpayer owning many assets could selectively sell only those assets with losses and thereby wipe out the tax on ordinary income even if those losses were offset by unrealized capital gains in the taxpayer's portfolio. This concern would support retention of a limitation on the deduction of capital or investment losses, even if capital or investment gains were not subject to preferential tax treatment and even though tax distinctions between investment and non-investment assets tend to generate disputes over the proper characterization of particular assets. Some have suggested a market-to-market system (parallel to present-law treatment of regulated futures contracts) for both gains and losses, at least in the case of publicly traded stock and securities or other readily valued assets. Others contend that limitation of such a system to these types of assets would retain possibilities for taxpayer manipulation.

Limits on the deductibility of capital losses may be unfair to taxpayers who have losses in excess of unrealized gains, since they may never get to deduct legitimate losses. Or, even if, over a period of years, the taxpayer can deduct his full loss, the present value of the deduction is reduced by deferral. The reduction in the value of the loss deduction creates an asymmetric treatment of gains and losses. This relative penalty on loss deduction may discourage taxpayers from undertaking risky investments. However, the ability of the taxpayer to defer realization of his gains at his discretion creates incentives to undertake such investments.

The present system—allowing the deduction of losses against up to $3,000 of ordinary income—is a compromise between the desire to be fair to taxpayers with net losses and the need to protect the tax base from selective realization of losses. In effect, small investors, who are presumed not to have large portfolios with unrealized gains, are allowed to deduct capital losses against ordinary income, and large investors, for whom $3,000 is not significant, are not. Arguably, however, large investors may have larger portfolios and lower transactional costs, making it easier selectively to realize accrued gains to offset losses and reduce the adverse impact of the $3,000 limit.

Reduction of long-term capital loss carryovers.—The prior law rule requiring that long-term losses be reduced by 50 percent when deducted against ordinary income (up to the $3,000 limit) was also a compromise between the need to protect the tax base and equity to investors with net capital losses. If long-term losses were fully deductible against ordinary income, as was the case before 1969, taxpayers with both long-term gains and losses could realize the gains and losses in alternate years, paying tax on only 40 percent of the gains and fully deducting the losses. Under prior law, a taxpayer who took care to realize losses before they became long-term could, of course, achieve this result despite the 50-percent reduction. To compensate for the loss limitation, Congress retained a 50-percent cutback, instead of increasing it to 60 percent, when the capital gains exclusion percentage was increased from 50 to 60 percent in 1978.

The Administration's proposal does not address this issue.

3. Definition of qualified assets

General.—The Administration's capital gains proposal is not targeted toward any particular type of equity investment although promotion of equity investment, and particularly high technology venture capital, is apparently a goal. Furthermore, the proposal affords capital gains treatment to non-equity investment such as gains on municipal bonds and other financial instruments.[19] The proposal also affords preferential capital gain treatment to land which is not directly productive in non-agricultural activities. On the other hand, the proposal denies the preference to collectibles as investments which do not contribute to economic growth. The proposal also denies the preference to certain forms of investment which receive other tax preferences such as depreciation allowances which are more generous than economic depreciation.

The proposal is not clear as to what rules would apply to prevent taxpayers from attempting to obtain the capital gains preference for sales of nonqualifying assets (e.g., collectibles or depreciable property) by contributing such assets to a C or an S corporation and selling the stock of that entity.[20] Certain disadvantages to holding such property in corporate form might discourage such activity; however, it is not clear that some taxpayers would not engage in such activity in the absence of strict look-through rules.

Depreciable assets used in a trade or business.—Although the Administration would retain the capital gains preference for assets that are "capital assets" under present law, it would eliminate the special capital gain/ordinary loss treatment of depreciable assets used in a trade or business. The Administration states that gains and losses from sales or other dispositions of depreciable property should be treated in the same manner as other business income or loss, including gains or losses from sales of other business property (e.g., inventory).[21] The Administration points out that the capital gain treatment of depreciable business assets arose historically in the wartime context of involuntary condemnations or requisitions coupled with high excess profit taxes, a situation no longer existing. Furthermore, the ACRS depreciation system accounts implicitly for inflation with respect to depreciable property. Thus, the Administration considers a preferential rate on gain from sales of such property to be unnecessary as an inflation adjustment or as an additional incentive for investment in depreciable property likely to yield significant gains on sale.[22]

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[19] Under prior law and present law, gains on futures contract are allocated as 60-percent long term and 40-percent short term. The Administration's proposal is unclear about whether 60-percent of gains on futures contracts would qualify for the new preferential tax rates.

[20] The proposal states that consideration would be given to rules denying the capital gains preference to sales of corporate stock to the extent collectibles had been contributed to the corporation by the selling shareholders.

[21] It is not clear whether there may be some exceptions to uniformity. For example, under the proposal, gain on dispositions of unpatented technology or certain patents would be ordinary income unless the asset qualified as a capital asset, but might not be in certain other (sec. 1235) patent dispositions.

Some proponents of preferential capital gains treatment of depreciable trade or business assets contend that, to the extent a purpose of favorable capital gains rates is to minimize "lock-in," this purpose should apply to depreciable business property as well as to other property. The "lock-in" argument for capital gains treatment usually assumes a high degree of taxpayer discretion in determining when to sell the particular types of assets eligible for capital gain treatment. Applying this argument to trade or business assets raises the question whether sales of some such assets are more discretionary than others. Some proponents also contend that capital gains treatment provides an investment incentive that remains desirable even though other incentives such as rapid depreciation may also be provided.

Land used in a trade or business.—The Administration proposal would retain the present law capital gains treatment for land used in a trade or business (and not held primarily for sale to customers). Losses on such property would also be treated as capital losses.

If land were considered an investment asset regardless of its use, capital loss as well as capital gains treatment is appropriate. On the other hand, if such land is considered a business asset, it is arguable that ordinary income treatment should follow. Decisions to dispose of land used in a trade or business may tend to relate to business cycles or other non-investment factors as much as would be the case for other trade or business assets, thus lessening the need to counter a "lock-in" effect. The ordinary loss treatment afforded land would be consistent with this view.

Treating land used in a trade or business in the same manner as other trade or business property could reduce a tax-motivated allocation of price between land and building. An allocation must be made by the buyer for depreciation purposes in any event, but it is not clear whether the seller would in all cases adopt the same allocation as the buyer.

4. Exclusion for certain taxpayers

The proposed 100-percent exclusion for certain taxpayers with adjusted gross incomes below $20,000 ($10,000 for single taxpayers) would remove all incentives, except brokerage costs, not to realize gains. Studies have indicated that realized gains of lower income taxpayers more frequently consist of purely inflationary gains. This exclusion would eliminate that possibility.

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[22] The Administration proposal affords capital gains treatment to items such as nondepreciable goodwill and going concern value. Since advertising, wages, and similar expenses contributing to the creation of such assets are currently deductible, some view the tax incentives for such assets as similar to accelerated depreciation, though others disagree.

To the extent certain types of know-how or technology are characterized nondepreciable assets eligible for the preference under the Administration's proposal, similar issues would arise where research and development costs of creating such assets are expensed. It is unclear to what extent particular items of know-how or technology might be characterized as nondepreciable (for example, because of the absence of an ascertainable useful life). Under present law, because there has been no recapture required on sales of such assets and the buyer generally wishes to obtain depreciation deductions, there has been little occasion for taxpayers to assert that such assets are nondepreciable. However, the Internal Revenue Service has successfully contended in some situations that such assets are nondepreciable. *See, e.g., Yates Industries v. Commissioner*, 58 T.C. 961 (1972), aff'd (3d Cir. 1973).

The Administration's proposal appears to create a cliff for those taxpayers with adjusted gross incomes at or near $20,000. Exceeding the $20,000 ceiling causes the capital gain exclusion to fall from 100 percent to 45 percent. This could create effective marginal tax rates in excess of 100 percent on some affected taxpayers' gain realizations.

Different exclusion percentages based upon taxpayer adjusted gross income may also create opportunities for income shifting from high income taxpayers to low income taxpayers. For example, in the absence of rules to restrict income shifting, under the Administration's proposal a taxpayer and his or her spouse holding an asset with an accrued capital gain of $18,000 could transfer the asset to their 15 year old child, and if the child had no other income, the child could realize the gain with no tax liability.[23]

C. Distributional Effects of a Reduction in Capital Gains Taxes

Table 2 below presents the staff of the Joint Committee on Taxation's estimate of the distributional effect of the Administration's proposal. The second column in the table below estimates the number of returns in each income class which will benefit from the proposed capital gains rate reduction. The third column reports the aggregate tax reduction which accrues to each income class. The fourth column calculates the average dollar tax reduction per return. The last column calculates the percentage of the aggregate tax change which accrues to each income class.

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[23] Presumably under the Administration's proposal, gains realized by children less than 14 years of age would be taxed at the same rate as the parents' capital gains.

Table 2.—Distributional Effect of the President's Capital Gains Proposal,[1] 1990 Income Levels

Income class[2]	Number of returns with tax change (thousands)	Aggregate tax change (millions of dollars)	Average tax reduction (dollars)	Percent distribution of aggregate tax change
Less than $10,000	72	−15	202	0.1
$10,000 to $20,000	695	−177	255	0.9
$20,000 to $30,000	1,216	−286	235	1.5
$30,000 to $40,000	1,498	−498	332	2.6
$40,000 to $50,000	1,083	−682	630	3.5
$50,000 to $75,000	1,581	−1,270	803	6.6
$75,000 to $100,000	539	−1,011	1,876	5.2
$100,000 to $200,000	875	−3,808	4,351	19.7
$200,000 and over	376	−11,603	30,820	60.0
Totals	7,935	−19,350	2,438	100.0

[1] This calculation assumes that qualified assets are held in the same proportions across income classes as are all assets.

[2] The income concept used to place tax returns into income classes is adjusted gross income plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside build-up on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences, from passive business activities.

Source: Joint Committee on Taxation Staff.

The table above calculates the benefit from the proposed rate reduction which taxpayers would receive if they realized the same amount of gains that they would have realized in the absence of a rate reduction. In other words, this calculation measures only the benefit the taxpayer receives if he or she does not alter behavior. This is a conservative estimate of the actual benefit, because it does not assume a behavioral response. If taxpayers respond by realizing additional gains they will obtain even more benefit from the change, since taxpayers change their behavior only if the change makes them even better off. Thus this calculation understates the benefit received by higher income taxpayers.

In other words, this table reports the distribution of the tax burden rather than the distribution of taxes paid. If a reduction in capital gains tax rates leads to greater realizations and tax revenue paid by high income taxpayers, the distribution of taxes paid will have shifted more onto high income taxpayers. However, an increase in the distribution of taxes paid does not imply that the tax burden on high income taxpayers has increased, because, as noted above, any additional tax paid in response to a capital gains rate cut results only from changed behavior.[24]

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[24] For further discussion on the appropriate methodology for assessing distributional effects, see Jane G. Gravelle and Lawrence B. Lindsey, "Capital Gains," *Tax Notes*, 38, January 25, 1988, pp. 397-405.

D. Indexing

Proponents of indexing contend that indexing would accomplish the goals of capital gains taxation while producing a more accurate measurement of economic income with greater neutrality.

Opponents contend that indexing is complex, should not be significant if efforts to control inflation are successful, and would erode revenues if such efforts are not successful.

1. Partial indexing

Where some but not all assets are indexed, several issues arise. To the extent that the basis of certain assets is indexed but debt-financing of those assets is not, the adjustment for inflation may be overstated.

If some but not all assets are indexed, additional consideration would have to be given to provisions designed to accomplish the desired results in certain special situations. For example, if stock but not debt is indexed, the question arises whether some types of assets, such as preferred stock or convertible debt, should be classified as stock or as debt for this purpose. Rules would be needed for assets that change categories, such as a personal residence converted to rental property (or vice versa). If an interest in an entity is eligible for indexing but the entity may hold substantial non-indexable assets, consideration could be given to provisions designed to prevent taxpayers from indirectly obtaining indexing for nonqualified assets.

Finally, so long as capital gains treatment remains available for some types of assets then, depending upon the rate of inflation, taxpayers may continue to have an incentive to engage in transactions designed to convert ordinary income to capital gains income.

2. Other indexing considerations

"Lock-in"

It is possible that indexing might not relieve "lock-in" problems, because a taxpayer whose after-tax economic gain is protected against future inflation may decide to continue to hold an asset to obtain the benefits of tax deferral, or the benefits of tax exemption if the asset is held until death. Others contend that indexing alleviates "lock-in" by removing the burden of taxing nominal gains arising from inflation.

Complexity

Indexing would involve a significant amount of recordkeeping. However, records of the cost of property and of improvements are generally maintained under present law. Records of the dates such costs are incurred would also be retained under present law where holding periods are important for capital gains purposes.

Indexing would substantially increase the volume of calculations necessary to calculate taxable gain for many common transactions. For example, consider an individual who sells stock which was purchased 10 years before the sale and who has reinvested the quarterly dividends in additional stock during this entire period. Under indexing, each of the 41 components of basis (the original purchase plus the 40 dividend payments) would be multiplied separately by different indexing factors in order to compute the inflation-adjusted value of that component and determine the basis of stock.

The interaction of indexing rules with other Code provisions would raise further issues. For example, the basis of a partnership interest or S corporation stock in the hands of a partner or shareholder is affected by numerous transactions, including distributions, that could complicate accurate indexing of such interests. Another example is the appropriate interaction of indexing with the short sale provisions of the Code.

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[JOINT COMMITTEE PRINT]

DESCRIPTION OF EXPIRING TAX PROVISIONS

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 13, 1989

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ERRATA

The following changes should be made to Description of Expiring Tax Provisions, published by the staff of the Joint Committee on Taxation on March 13, 1989, as JCS-8-89.

(1) On page 7, the first sentence of the last paragraph should read as follows: There are no statutory R&D allocation and apportionment rules applicable to years after the year governed by TAMRA.

(2) On page 23, the date in the last sentence of the last paragraph should be changed from January 1, 1989 to January 1, 1990.

(3) On page 25, the third and fourth sentences of the last paragraph should read as follows: The Deficit Reduction Act of 1984 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities to December 31, 1988. The Tax Reform Act of 1986 extended that sunset date to December 31, 1989.

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of certain tax provisions that expired in 1988 and of provisions scheduled to expire in 1989.[2]

The first part of the pamphlet is a summary listing of tax provisions that were extended by the Technical and Miscellaneous Revenue Act of 1988 and expired in 1988 and of tax provisions scheduled to expire in 1989. The second part provides a brief description of these expired and expiring tax provisions, including reference to recent legislative background.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Expiring Tax Provisions* (JCS-8-89), March 13, 1989.

[2] Several of these proposals are also described in Joint Committee on Taxation, *Summary of Revenue Provisions in President Bush's Fiscal Year 1990 Budget Proposal* (JCS-6-89), March 3, 1989.

I. SUMMARY

Expired tax provisions

The following tax provisions expired at the end of 1988, unless otherwise indicated:

(1) Rules for allocation and apportionment of research expenses (expired at the end of the fourth month of the taxpayer's first taxable year beginning after August 1, 1987);

(2) Exclusion for employer-provided educational assistance benefits; and

(3) Exclusion for group legal services benefits, and tax exemption for an organization providing group legal services or indemnification against the cost of legal services as part of a qualified group legal services plan.

Expiring tax provisions

The following tax provisions are scheduled to expire at the end of 1989:

(1) 20-percent tax credit for qualified research expenditures;

(2) Targeted jobs tax credit;

(3) 10-percent energy tax credits for solar and geothermal property, and 15-percent credit for ocean thermal property;

(4) Tax exemption for qualified mortgage bonds and election to issue mortgage credit certificates;

(5) Certain rules relating to financially troubled financial institutions (reorganizations, net operating losses, and FSLIC/FDIC assistance payments);

(6) Treatment of mutual fund shareholder expenses for purposes of the 2-percent floor on miscellaneous itemized deductions;

(7) Qualified small-issue bonds;

(8) Low-income housing tax credit;

(9) Deductibility of health insurance costs of self-employed individuals;

(10) The ESOP exception to the additional tax on early withdrawals from qualified retirement plans; and

(11) The $2 million exception to the generation-skipping transfer tax.

II. DESCRIPTION OF PROVISIONS

A. Expired Tax Provisions

1. Allocation and apportionment of research expenses (secs. 861(b), 862(b), and 863(b) of the Code)

Present Law [3]

In general

U.S. persons are taxable on their worldwide income, including their foreign income. A U.S. person that earns foreign income may incur foreign income tax. Subject to the applicable foreign tax credit limitations, such a person may credit foreign income taxes against its U.S. tax liability. The purpose of the foreign tax credit and the foreign tax credit limitations is to yield primary taxing jurisdiction over U.S. persons' foreign income to foreign governments, while retaining residual taxing jurisdiction over such income for the United States and ensuring that the full U.S. tax is paid on domestic income.

The foreign tax credit limitations operate by separating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") into 2 categories: tax on U.S. source taxable income and tax on foreign source taxable income. Pre-credit U.S. tax on foreign source taxable income is further subdivided by limitation categories, or "baskets," of income. The pre-credit U.S. tax on any particular limitation category of foreign source income serves as the upper limit on credits for foreign taxes on that type of income.

Each foreign tax credit limitation equals total pre-credit U.S. tax times the ratio of the taxable income in that limitation category to worldwide taxable income. Foreign source taxable income equals foreign source gross income less the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any deductions which cannot definitely be allocated to some item or class of gross income (Code sec. 862(b)). Deductions allocated and apportioned to foreign source gross income must be further allocated or apportioned among the separate limitation categories of foreign source gross income in order to arrive at foreign source taxable income in any one limitation category. Finally, allocation and apportionment of deductions to U.S. source gross income determines the amount of taxpayer's U.S. source taxable income (sec. 861(b)).

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[3] Some of the provisions discussed in this section were treated more comprehensively in Part III of the April 2, 1987 pamphlet, prepared by the staff of the Joint Committee on Taxation for the Senate Committee on Finance, entitled Description of Proposals Relating to Research and Development Incentive Act of 1987 (S. 58) and Allocation of R&D Expenses to U.S. and Foreign Income (S. 716) (JCS-6-87).

The Code generally articulates only the broad principles of how expenses reduce U.S. and foreign source gross income, leaving the Treasury Department to provide detailed rules for the generally fact-specific task of allocating and apportioning expenses. The application of regulations to particular facts and circumstances, therefore, has a significant role in determining the proportions of taxpayers' worldwide taxable income that are treated as derived from foreign sources. These proportions control, in turn, the level of taxpayers' foreign tax credit limitations.

A taxpayer that has paid less foreign tax in each limitation category than the foreign tax credit limitation with respect to that category credits all of its foreign income tax against pre-credit U.S. tax (such a taxpayer is said to have "excess limit" in each of its limitation categories). If the rules for allocating and apportioning deductions are then changed to permit foreign source deductions to be converted to U.S. source deductions, with the result that a greater proportion of the taxpayer's worldwide taxable income is deemed to come from foreign sources, the change cannot decrease the taxpayer's U.S. tax liability on its worldwide income. A taxpayer that has paid foreign taxes in excess of one or more of its foreign tax credit limitations (that is, a taxpayer with "excess credits") cannot currently use all of its foreign income taxes as credits. In this case, a change in the allocation and apportionment rules may result in additional use of foreign tax credits, as follows: The conversion of a foreign source deduction to a U.S. source deduction converts an amount of U.S. source taxable income to foreign source taxable income, thus increasing the foreign tax credit limitation and reducing the taxpayer's current U.S. tax liability by approximately 34 cents for each dollar of deduction that is converted from foreign to U.S. source. Conversely, upon a change in the allocation rules that shifts deductions from U.S. to foreign income, a taxpayer with excess credits (or a taxpayer that previously had excess limit and finds itself, as a result of the rule change, with excess credits) may experience an increase in U.S. tax liability due to a reduction in the amount of its foreign income taxes that remain creditable.

Treasury Regulation sec. 1.861-8(e)(3)

Treasury Regulations promulgated in 1977 prescribe detailed rules for allocating and apportioning research and experimental expenses for purposes of computing the foreign tax credit limitation of a U.S. person, as well as for other purposes (Treas. Reg. sec. 1.861-8(e)(3)) ("the R&D regulation").[4]

The R&D regulation contemplates that taxpayers will sometimes undertake R&D solely to meet legal requirements. In some such cases, the R&D cannot reasonably be expected to generate income (beyond *de minimis* amounts) outside a single geographic source. If so, those deductible R&D expenses reduce gross income only from the geographic source that includes that jurisdiction.

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[4] By its terms, the R&D regulation would also apply, for example, in determining the U.S. source taxable income of a foreign person, and the taxable income effectively connected with a U.S. trade or business conducted by a foreign person, insofar as those determinations are necessary under other "operative" Code sections. The operative section for the foreign tax credit limitation is section 904(a).

After allocating deductions to meet legal requirements, the regulation generally allows 30 percent of deductible R&D expenses to reduce gross income from the source where over half of the taxpayer's total deductible R&D expenses are incurred. A taxpayer has the opportunity to apportion more than 30 percent of its R&D deduction exclusively to the source where R&D is performed if it can establish that a significantly higher percentage is warranted because the R&D is reasonably expected to have a very limited or long-delayed application outside that geographic source.

After a taxpayer makes a place-of-performance apportionment, it must apportion the amount of its R&D deduction remaining, if any, on the basis of relative amounts of domestic and foreign sales receipts. Subject to certain limitations, a taxpayer may elect to apportion its R&D deduction under an optional gross income method instead of the sales method. Under a gross income method, a taxpayer generally apportions its R&D deduction (after allocation under the legal requirements test but not the place-of-performance test) on the basis of relative amounts of gross income from domestic and foreign sources. The basic limitation on the use of optional gross income methods is that the respective portions of a taxpayer's R&D deduction apportioned to U.S. and foreign source income using a gross income method may not be less than 50 percent of the respective portions that would be apportioned to each such income grouping using the sales apportionment method (with the latter's exclusive place-of-performance allocation, typically 30 percent).

Legislative Background

Starting in 1981, Congress enacted a series of statutory R&D allocation rules to substitute, in part, for the R&D regulation. The first statutory R&D allocation rule was contained in the Economic Recovery Tax Act of 1981 (ERTA), covering any taxpayer's first 2 taxable years beginning within 2 years after August 13, 1981. In the taxable years governed by this aspect of ERTA, all U.S.-incurred R&D expenses were allocated to U.S.-source income. This provision was extended by the Deficit Reduction Act of 1984 (DEFRA) and the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) through taxable years beginning on or before August 1, 1986.

For taxable years beginning after August 1, 1986, and on or before August 1, 1987, the Tax Reform Act of 1986 (TRA) provided that 50 percent of research expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were allocated to U.S. source income, with the remainder allocated and apportioned either on the basis of sales or gross income. In contrast with the R&D regulation, the temporary rule of TRA (1) gave taxpayers using the gross sales method of apportionment an automatic place-of-performance allocation, for U.S.-incurred R&D, of 50 (rather than 30) percent; (2) allowed taxpayers using the gross income apportionment method to use the automatic place-of-performance rule; and (3) imposed no limit on the extent to which use of the gross income method could result in decreasing the amount of R&D expenses that would otherwise be allocated to foreign source income using the gross sales method.

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) effectively extended statutory allocation rules for an additional four months. The rules in effect for these four months, however, were different than those contained in previous statutes. Expenses incurred during the taxable year governed by TAMRA (for any taxpayer, its first taxable year beginning after August 1, 1987) were deemed to be incurred ratably throughout the year. For expenses deemed to have been incurred in the first four months of the year (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source), 64 percent of U.S.-incurred R&D expenses were allocated to U.S. source income, 64 percent of foreign-incurred R&D expenses were allocated to foreign source income, and the remainder of R&D expenses were allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment was used, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used. For expenses deemed to have been incurred during the remaining eight (or fewer) months of the year governed by TAMRA, the R&D allocation regulation applied.

There are no statutory R&D allocation and apportionment rules applicable to years governed by TAMRA. Thus, the R&D regulation generally governs allocation and apportionment of U.S.-incurred R&D expenses (as well as foreign-incurred R&D expenses) in all taxable years beginning after August 1, 1988.

2. Exclusion for employer-provided educational assistance (sec. 127 of the Code)

Prior Law

Under present law, an employee must include in income and wages, for income and employment tax purposes, the value of educational assistance provided by an employer to an employee, unless the cost of such assistance qualifies as a deductible job-related expense of the employee. Amounts expended for education qualify as deductible job-related expenses if the education (1) maintains or improves skills required for the employee's current job, or (2) meets the express requirements of the individual's employer that are imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5(a)). In the case of an employee, such expenses (if not reimbursed by the employer) are deductible only to the extent that, when aggregated with other miscellaneous itemized deductions, they exceed 2 percent of the taxpayer's adjusted gross income. No deduction is allowed for expenses incurred to qualify for a new trade or business (e.g., for law school tuition paid by a paralegal or accountant).

Under prior law, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (sec. 127). This exclusion, which expired for taxable years beginning after December 31, 1988, was limited to $5,250 of educational assistance with respect to an individual during a calendar year. In addition, for taxable years beginning after 1987, the exclusion did not apply to graduate level courses. Specifically, the exclusion did not apply to any payment for, or the provision of any benefits with respect to, any course taken by an employee who had a bachelor's degree or was receiving credit toward a more advanced degree, if the particular course could be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.

Section 127 required, among other things, that educational assistance provided under such a program not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that if the section 127 exclusion for educational assistance were extended, the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion in lieu of the prior-law rules.

Legislative Background

The section 127 exclusion was first established on a temporary basis by the Revenue Act of 1978 (through 1983). It subsequently was extended, again on a temporary basis, by Public Law 98-611 (through 1985), by the Tax Reform Act of 1986 (through 1987), and by the Temporary and Miscellaneous Revenue Act of 1988 (through 1988, with the limitation that the exclusion does not apply to graduate level courses).

3. Exclusion for employer-provided group legal services; tax exemption for qualified group legal services organizations (secs. 120 and 501(c)(20) of the Code)

Prior Law

Under prior law, amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) were excluded from the employee's gross income for income and employment tax purposes (sec. 120). The exclusion also applied to any services received by an employee (or the employee's spouse or dependents) or any amounts paid to an employee under such a plan as reimbursement for the cost of legal services for the employee (or the employee's spouse or dependents). The exclusion was limited to an annual premium value of $70. In order to be a qualified plan under which employees were entitled to tax-free benefits, a group legal services plan was required to fulfill certain requirements. The exclusion for group legal services benefits expired for taxable years ending after December 31, 1988.

In addition, prior law provided tax-exempt status for an organization the exclusive function of which was to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan (sec. 501(c)(20)). The tax exemption for such an organization expired for taxable years ending after December 31, 1988.

Section 120 required, among other things, that group legal service benefits provided under a qualified plan not discriminate in favor of highly compensated employees in certain respects. The Statement of Managers for the Tax Reform Act of 1986 indicated that the new nondiscrimination rules for employee benefits added by the 1986 Act (sec. 89) were to be applied to the exclusion for group legal service benefits in lieu of the prior-law rules if the exclusion was extended for any period after the effective date of section 89.

In 1984, Congress required that employers file information returns with respect to qualified group legal services plans (sec. 6039D). This requirement was intended to collect data with respect to the use of such plans so that Congress could evaluate the effectiveness of the exclusion.

Legislative Background

The section 120 exclusion and the section 501(c)(20) exemption were enacted initially on a temporary basis by the Tax Reform Act of 1976 (through 1981). They subsequently were extended, again on a temporary basis, by the Economic Recovery Act of 1981 (through 1984), Public Law 98-612 (through 1985), the Tax Reform Act of 1986 (through 1987), and the Technical and Miscellaneous Revenue Act of 1988 (through 1988).

B. Tax Provisions Expiring in 1989

1. Tax credit for qualified research expenditures (sec. 41 of the Code)

Present Law

General rule

A 20-percent tax credit is allowed for qualified research expenditures incurred by a taxpayer in carrying on a trade or business. Except for certain university basic research payments, the credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period, which generally is the preceding three taxable years.

Eligible expenditures

Research expenditures eligible for the 20-percent incremental credit under present law consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research; (2) certain time-sharing costs for computer use in research; and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Under the 1986 Act, a 20-percent tax credit also applies to the *excess* of (1) 100 percent of corporate cash expenditures (including grants or contributions) paid for university basic research *over* (2) the sum of (a) the greater of two fixed research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed base period, as adjusted for inflation.

The amount of credit-eligible basic research expenditures to which the university basic research credit applies does not enter into the computation of the incremental credit. The remaining amount of credit-eligible basic research expenditures—i.e., the amount to which the university basic research credit does not apply—enters into the incremental credit computation (and in subsequent years enters into the base period amounts for purposes of computing the incremental credit).

Research definition

The 1986 Act provided statutory rules defining qualified research for purposes of the incremental credit. These rules target the credit to research undertaken to discover information that is technological in nature and that pertains to functional aspects of products. Also, the 1986 Act expressly excluded certain types of expenditures from eligibility for the credit, including post-production research activities, duplication or adaptation costs, and surveys, studies, and certain other costs. The definitional modifications were effective for taxable years beginning after 1985.

Relation to deduction

For taxable years beginning prior to 1989, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures was not reduced by the amount of any credit allowed to the taxpayer for the same qualified research expenditures. For taxable years beginning after 1988, however, the amount of any deduction allowable to a taxpayer under section 174 or any other provision for qualified research expenditures is reduced by an amount equal to 50 percent of the taxpayer's section 41 credit determined for that year. A similar rule applies if the taxpayer capitalizes, rather than expenses, qualified research expenditures pursuant to section 174.

Computation of allowable credit

General rule.—The credit applies to the amount of qualified research expenditures for the current taxable year that exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

New businesses.—For a base period year during which it was not in existence, a new business is treated as having research expenditures of zero for purposes of computing average annual research expenditures during the base period. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule.—In computing the credit, the amount of base period research expenditures to be subtracted from current-year expenditures is treated as at least equal to 50 percent of the taxpayer's qualified research expenditures for the current year. This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

Aggregation rules.—To ensure that the credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of certain related persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Changes in business ownership.—Special rules apply for computing the credit when a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

Trade or business limitations

The credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception relating to certain research joint ventures, the trade or business test for purposes of the credit is the same as for purposes of the business deduction provisions of section 162. Thus, for example, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner that is an operating company) for partnership expenditures for outside or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments. Under the trade or business test, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on by the taxpayer.

Other limitations and carryover

The 1986 Act made the research credit subject to the general business credit limitation (i.e., 75 percent of tax liability over $25,000), effective for taxable years beginning after 1985. Any excess amount of the general business credit can be carried back three years and carried forward 15 years, beginning with the earliest year.

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income that is allocable or apportionable to such interest. Any excess credit amount is eligible for the carryover rule described above.

Legislative Background

As enacted in the Economic Recovery Tax Act of 1981, the rate of the credit was 25 percent, and the credit was scheduled to expire after December 31, 1985. In the Tax Reform Act of 1986, the credit was extended for three years (i.e., for qualified research expenditures through December 31, 1988); also, the credit rate was reduced to 20 percent of the incremental research expenditure amount, effective for taxable years beginning after 1985.

The Technical and Miscellaneous Revenue Act of 1988 extended the credit for one additional year through December 31, 1989. The Act also reduced the deduction allowed under section 174 for qualified research expenditures by an amount equal to 50 percent of the taxpayer's research credit determined for the year.

2. Targeted jobs tax credit (sec. 51 of the Code)

Present Law

Tax credit provisions

The targeted jobs tax credit is available on an elective basis for hiring individuals from nine targeted groups. The targeted groups are: (1) vocational rehabilitation referrals; (2) economically disadvantaged youths aged 18 through 22; (3) economically disadvantaged Vietnam-era veterans; (4) Supplemental Security Income (SSI) recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students aged 16 through 19; (7) economically disadvantaged former convicts; (8) Aid to Families with Dependent Children (AFDC) recipients and Work Incentive (WIN) registrants; and (9) economically disadvantaged summer youth employees aged 16 or 17. Certification of targeted group membership is required as a condition of claiming the credit.

The credit generally is equal to 40 percent of the first $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit is not available for wages paid to a targeted group member unless the individual either (1) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (2) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Also, the employer's deduction for wages must be reduced by the amount of the credit claimed.

The credit is available with respect to targeted-group individuals who begin work for the employer before January 1, 1990.

Authorization of appropriations

Present law also authorizes appropriations for administrative and publicity expenses relating to the credit through September 30, 1989. These monies are to be used by the Internal Revenue Service (IRS) and Department of Labor to inform employers of the credit program.

Legislative Background

Extension of credit, authorization of appropriations

The targeted jobs tax credit was enacted in the Revenue Act of 1978 to replace an expiring credit for increased employment. As originally enacted, the targeted jobs credit was scheduled to terminate after 1981.

The availability of the credit was successively extended by the Economic Recovery Tax Act of 1981 (ERTA) for one year (through 1982), the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) for two years (through 1984), and the Deficit Reduction Act of 1984 (the 1984 Act) for one year (through 1985).

The Tax Reform Act of 1986 extended the targeted jobs credit for three additional years (through 1988), with modifications. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) extended the credit with modifications for one additional year (through 1989).

TEFRA authorized appropriations for the expenses of administering the system, for certifying targeted group membership, and for providing publicity to employers regarding the targeted jobs credit. The 1984, 1986, and 1988 Acts successively extended the authorization for appropriations for administrative and publicity expenses through fiscal year 1989.

Modification of credit

ERTA, TEFRA, and the 1984 Act modified the targeted group definitions and made several technical and administrative changes in the credit provisions.

The 1986 Act limited the extended credit in three respects: (1) a 25-percent credit for qualified wages paid in the second year of a targeted-group individual's employment was repealed; (2) a 50-percent credit for qualified first-year wages generally was reduced to a 40-percent credit (except that the credit allowed for wages of economically disadvantaged summer youth employees was retained at 85-percent of up to $3,000 of qualified first-year wages); and (3) no wages paid to a targeted-group member are taken into account for credit purposes unless the individual either (a) is employed by the employer for at least 90 days (14 days in the case of economically disadvantaged summer youth employees), or (b) has completed at least 120 hours of work performed for the employer (20 hours in the case of economically disadvantaged summer youth employees). Under the 1986 Act, the modified credit is available for wages paid to targeted-group individuals who begin work for an employer after December 31, 1985 and before January 1, 1989.

As a result of the Omnibus Budget Reconciliation Act of 1987, the credit is no longer available for wages paid to a targeted-group individual who performs the same or substantially similar services as an employee participating in, or affected by, a strike or lockout.

Two modifications were also made to the credit in TAMRA: (1) the category of economically disadvantaged youth was restricted to include employees age 18 to 22 rather than employees age 18 to 24, and (2) the credit percentage for disadvantaged summer youth employees was reduced from 85 percent to 40 percent.

3. Business energy tax credits for solar, geothermal, and ocean thermal property (secs. 46(a)(2) and 46(b)(2)(A)(viii), (ix), and (x) of the Code)

Present Law

A nonrefundable energy tax credit is allowed for certain investments in solar property, geothermal property, and ocean thermal property. For solar and geothermal properties, the rate of the credit is 10 percent in 1989. The rate of the credit for ocean thermal property is 15 percent in 1989. The energy tax credits for solar, geothermal, and ocean thermal properties are not available for properties placed in service after December 31, 1989.[5]

Legislative Background

The energy tax credits for solar and geothermal properties were enacted in the Energy Tax Act of 1978, effective through 1982. The credit for ocean thermal property was enacted in the Windfall Profit Tax Act of 1980, effective through 1985, and in the same act, the solar and geothermal credits were extended through December 31, 1985. In the Tax Reform Act of 1986, these three credits were extended for three additional years (through 1988) at rates which phased down to the present rates. The Technical and Miscellaneous Revenue Act of 1988 extended these credits for one additional year, through December 31, 1989.

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[5] For definition of solar, geothermal, and ocean thermal property, see Code sections 48(l)(4), 48(l)(3)(A)(viii), and 48(l)(3)(A)(ix), respectively.

4. Qualified mortgage bonds and mortgage credit certificates (secs. 143 and 25 of the Code)

Present Law

Qualified mortgage bonds

In general, mortgage revenue bonds qualifying for tax-exemption under section 103 of the Code ("qualified mortgage bonds") are bonds the proceeds of which are used (net of costs of issuance and a reasonably required reserve fund) to finance the purchase, or qualifying rehabilitation or improvement, of single-family, owner-occupied homes located within the jurisdiction of the issuer of the bonds.

First-time homebuyer requirement

An issue is a qualified mortgage issue only if at least 95 percent of the net proceeds of the issue are used to finance residences for mortgagors without present ownership interests in their principal residences during the three-year period before their respective mortgages are executed. This first-time homebuyer requirement does not apply to mortgagors of residences located in targeted areas (as described below), mortgagors who receive qualified home improvement loans, or mortgagors who receive qualified rehabilitation loans.

Income limitations

Qualified mortgage bond financing is available only to mortgagors whose family incomes do not exceed 115 percent (100 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income.

An adjustment to the mortgagor's qualifying income limitation is made for high housing cost areas. For purposes of this provision, the applicable income limit for the mortgagor will be the highest of 115 percent (100 percent for families of fewer than three persons) of area median gross income, the adjusted income limit determined for high housing cost areas, or 115 percent (100 percent for families of fewer than three persons) of the State median gross income. Family income of mortgagors (as well as area median gross income) is to be determined by the Treasury Department after taking into account the regulations under section 8 of the United States Housing Act of 1937.

In targeted areas, two-thirds of the mortgage financing provided with the proceeds of each issue must be provided to mortgagors who have family incomes not exceeding 140 percent (120 percent for families of fewer than three persons) of the higher of (1) the median gross income for the area in which the residence is located, or (2) the Statewide median gross income. The remaining one-third of the mortgage financing of each issue may be used to provide mortgage loans without regard to income limitations. A targeted area is defined as (1) a census tract in which at least 70 percent of the families have incomes that are 80 percent or less of the Statewide median family income, or (2) an area of chronic economic distress designated by the Secretary of the Treasury and the Secretary of Housing and Urban Development.

Purchase price limitations

The acquisition cost of a residence financed with qualified mortgage bonds may not exceed 90 percent (110 percent in targeted areas) of the average area purchase price applicable to the residence. The determination of average area purchase prices is made separately (1) with respect to new residences and existing, previously occupied residences, and (2) to the extent provided in regulations, with respect to one-, two-, three-, and four-family residences.

Loan origination and loan prepayment rules

All unspent proceeds remaining 3 years after the date of issuance of qualified mortgage revenue bonds must be used to redeem bonds within the next six months. The amount of any loans originated during that 6-month period will reduce the amount of bonds to be redeemed by the amount of such loans. Generally, the amounts of regular loan repayments and prepayments which are received ten years or more after the date the bonds are issued must be used to redeem bonds. A *de minimis* exemption of $250,000 is allowed from these redemption requirements. Repayments received during the 10-year period following original issuance may be used to make new loans.

Recapture

All or part of the subsidy provided by qualified mortgage revenue bond financing or mortgage credit certificates (described below) is recaptured on dispositions of assisted housing which occur within 10 years of purchase by mortgagors whose incomes increased substantially since purchase of their homes. The maximum amount recaptured is 1.25 percent of the original balance of the loan for each year the loan is outstanding, or 50 percent of the gain realized on the disposition, whichever is less. For sales in years six through 10, the 1.25 percent per year is phased out. This recapture provision only applies to loans originated, and mortgage credit certificates issued, after December 31, 1990.

Mortgage credit certificates

Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle homebuyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are generally subject to the same eligibility and targeted area requirements as qualified mortgage bonds.

Each MCC must represent a credit for 10 to 50 percent of interest on qualifying mortgage indebtedness. The actual dollar amount of an MCC depends on the amount of qualifying interest paid during any particular year and the applicable certificate credit percentage. If the credit percentage exceeds 20 percent, however, the dollar amount of the credit received by the taxpayer for any year may not exceed $2,000.

The aggregate amount of MCCs distributed by an electing issuer may not exceed 25 percent of the volume of qualified mortgage bond authority exchanged by the State or local government for authority to issue MCCs. For example, a State that is authorized to issue $200 million of qualified mortgage bonds and that elects to exchange $100 million of that bond authority can distribute an aggregate amount of MCCs equal to $25 million.

Legislative Background

The Mortgage Subsidy Bond Act of 1980 imposed restrictions on the ability of State and local governments to issue tax-exempt bonds to finance mortgage loans on single-family, owner-occupied residences. The 1980 Act provided that interest on mortgage subsidy bonds would be exempt from taxation only if the bonds were "qualified veterans' mortgage bonds" or "qualified mortgage bonds."

The authority of State and local governments to issue tax-exempt qualified mortgage bonds under the 1980 Act expired on December 31, 1983. The Deficit Reduction Act of 1984 extended this authority (with modifications) through December 31, 1987.

The authority to issue qualified mortgage bonds and the election to trade in bond volume authority to issue MCCs were extended for one year, through December 31, 1988, by the Tax Reform Act of 1986, and for another year, through December 31, 1989, by the Technical and Miscellaneous Revenue Act of 1988.

5. Financially troubled financial institutions: reorganizations, NOLs, and FSLIC/FDIC assistance payments (secs. 368(a)(3)(D), 382(l)(5)(F), and 597 of the Code)

Present Law

Continuity of interest requirement

In order for the acquisition of a financially troubled financial institution to qualify as a tax-free reorganization, the acquisition must satisfy the judicially-created "continuity of interest" requirement. The continuity of interest doctrine generally requires that the shareholders of an acquired corporation maintain a meaningful ownership interest in the acquiring corporation in order for the transaction to qualify as a tax-free "reorganization" within the meaning of section 368(a). Without special reorganization rules (described below), there is often uncertainty under what circumstances the continuity of interest requirement is met, especially in the case of mutually-owned thrift institutions.

A special rule adopted in the Economic Recovery Tax Act of 1981 (the "1981 Act") provides that the continuity of interest requirement need not be satisfied in the case of certain mergers involving financially troubled thrift institutions. In the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"), this special rule was expanded to cover certain mergers of financially troubled banks.

Under present law, a merger involving a financially troubled financial institution need not satisfy the continuity of interest requirement provided the following three requirements are met (sec. 368(a)(3)(D)). First, the acquired institution must be one to which section 593 (a savings and loan association, a cooperative bank, or a mutual savings bank) or section 585 (a bank) applies. Second, a certification that the acquired financial institution is financially troubled must be issued by the specified organization having supervisory authority over the financial institution. Third, substantially all the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization under section 368(a)(1)(D).

Net operating loss carryovers

In a tax-free reorganization, the acquiring corporation generally succeeds to the tax attributes of the acquired corporation, including its net operating and built-in loss carryovers, subject to certain limitations contained in section 382. Under the rules providing limitations on net operating loss carryovers before the Tax Reform Act of 1986 ("old section 382"), the net operating loss carryovers of a corporation were reduced if the shareholders of the corporation with the net operating loss carryover did not own at least 20 percent of the stock in the corporation surviving the reorganization. The Tax Reform Act of 1986 (the "1986 Act") revised these limitations on net operating and built-in loss carryovers. In general, under present-law section 382, the ability of an acquiring corporation to utilize to the net operating and built-in loss carryovers of a corporation acquired in a tax-free reorganization is limited if there has been more than a 50-percent change in the ownership of the acquired corporation.

The 1981 Act contained a special rule which relaxed the loss limitation provisions of old section 382 applicable to tax-free reorganizations involving financially troubled thrift institutions. The 1986 Act continued to provide a similar special rule under present-law section 382 for financially troubled thrift institutions. The 1988 Act expanded this special rule to cover tax-free reorganizations of financially troubled banks.

Under present law, in the case of a tax-free acquisition of a financially troubled financial institution, the depositors of such institution whose deposits are assumed by the acquiring corporation are deemed to continue an equity interest in the reorganized financial institution. In addition, the percentage ownership that must be retained so as not to trigger the application of the limitation on losses under section 382 is reduced from 50 percent to 20 percent (sec. 382(l)(5)(F)).

Assistance payments to financially troubled financial institutions

Under general tax principles, the tax treatment of payments from the Federal Savings and Loan Insurance Corporation (FSLIC) or the Federal Deposit Insurance Corporation (FDIC) to a financial institution is unclear. A payment can be treated as gross income to the recipient financial institution or otherwise reduce the amount of any insured loss. Alternatively, taxpayers may take the postition that a payment is a contribution to the capital of the financial institution, in which case it would not be includible in gross income (sec. 118). If the payment is characterized as a contribution to capital, the tax consequences would vary depending upon whether the payment was treated as a non-shareholder or shareholder contribution to capital. If characterized as a non-shareholder contribution to capital, the basis of property held by the recipient financial institution normally would be reduced by the amount of such contribution (sec. 362(c)). If characterized as a shareholder contribution to capital, there would be no basis adjustment.

The 1981 Act provided that financially troubled thrift institutions may exclude financial assistance by the FSLIC from income and need not reduce their basis in property by the amount of such financial assistance (sec. 597). In the 1988 Act, this special rule was expanded to provide that financially troubled banks may exclude financial assistance by the FDIC from income and need not reduce their basis in property by the amount of such financial assistance. In addition, the 1988 Act provided, in general, for a reduction in certain tax attributes of a financially troubled financial institution equal to 50 percent of the amount of assistance provided by the FSLIC or the FDIC and excluded from the gross income of the financial institution under section 597.

Legislative Background

The Economic Recovery Tax Act of 1981 provided special rules applicable to financially troubled thrift institutions (described above). The Tax Reform Act of 1986 provided that the special rules would terminate at the end of 1988. The Technical and Miscellaneous Revenue Act of 1988 extended for one year (through 1989) the effective date of the repeal of these provisions and made certain modifications to the provisions, including the extension of these provisions to financially troubled banks.

6. Treatment of mutual fund shareholder expenses for purposes of the 2-percent floor on miscellaneous itemized deductions (sec. 67(c) of the Code)

Present Law

Miscellaneous employee and investment expenses generally are deductible by itemizers only to the extent that they exceed 2-percent of the taxpayer's adjusted gross income. Investment expenses indirectly incurred by a taxpayer through a pass-through entity, such as a mutual fund, do not directly reduce the amount of the entity's income that is taxable to the taxpayer, but are deducted by the taxpayer as miscellaneous deductions subject to the 2-percent floor.

In the Technical and Miscellaneous Revenue Act of 1988, Congress intended to exclude certain mutual fund expenses from miscellaneous itemized duductions subject to the 2-percent floor until taxable years beginning after December 31, 1989.[6] Because of a drafting error, mutual fund expenses were indefinitely excluded from miscellaneous itemized deductions. Accordingly, a technical correction may be required to reflect Congressional intent that mutual fund expenses be included in miscellaneous itemized deductions subject to the 2-percent floor in taxable years beginning after December 31, 1989.

Legislative Background

The Tax Reform Act of 1986 would have treated certain investment expenses of publicly offered mutual funds as miscellaneous itemized deductions (subject to the 2-percent floor) for taxable years beginning after December 31, 1986. The Omnibus Budget Reconciliation Act of 1987 delayed such treatment until taxable years beginning after December 31, 1987. Under the Technical and Miscellaneous Revenue Act of 1988, such treatment would not occur in taxable years beginning prior to January 1, 1989.

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[6] H. Rep. 100-1104, Vol. II (October 21, 1988) p. 92 (Conference Report).

7. Qualified small-issue bonds (sec. 144(a) of the Code)

Present Law

Interest on certain small issues of private activity bonds is exempt from tax if at least 95 percent of the bond proceeds is used to finance manufacturing facilities or certain land or property for first-time farmers ("qualified small-issue bonds").

Qualified small-issue bonds are issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Special limits apply to bonds for first-time farmers. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of certain related capital expenditures during the 6-year period beginning three years before the date of the issue and ending three years after that date, may not exceed $10 million. In determining whether an issue meets the requirements of the small-issue exception, previous small issues (and in the case of the $10-million limitation, capital expenditures during a 6-year period) are taken into account if (1) they are used with respect to a facility located in the same incorporated municipality or the same county (but not in any incorporated municipality) as the facility being financed with the qualified small-issue bonds, and (2) the principal users of both facilities are the same, or two or more related persons.

The aggregate amount of qualified small-issue bond financing for all types of depreciable farm property (including both new and used property) is limited to $250,000 for any person or related persons. The $250,000 is a lifetime limit.

Capital expenditures not included for purposes of the $10 million limit are expenditures (1) made to replace property destroyed or damaged by fire, storm, or other casualty; (2) required by a change in Federal, State, or local law made after the date of issue; (3) subject to a $1 million limit, required by circumstances that reasonably could not be foreseen on the date of issue; or (4) qualifying as in-house research expenses (excluding research in the social sciences or humanities and research funded by outside grants or contracts).

Interest on qualified small-issue bonds is taxable if the aggregate face amount of all outstanding tax-exempt private activity bonds (including exempt-facility bonds, qualified redevelopment bonds, and qualified small-issue bonds) that would be allocated to any beneficiary (other than a section 501(c)(3) organization) of the qualified small-issue bonds exceeds $40 million. Bonds that are to be redeemed with the proceeds of a new issue (other than in an advance refunding) are not considered. Certain current refunding bonds are also not taken into account.

For purposes of the $40 million limitation, the face amount of any issue is allocated among persons who are owners or principal users of the bond-financed property during a 3-year test period. This may result in all or part of a facility being allocated to more than one person, as when one person owns bond-financed property and other persons are principal users, or when owners and/or principal users change during the 3-year test period. Once an allocation to a test-period beneficiary is made, that allocation remains in effect as long as the bonds are outstanding, even if the beneficiary no longer owns or uses the bond-financed property. If the $40 million limit is exceeded for any owner or principal user as a result of a change during the test period, interest on the issue of qualified small-issue bonds that caused the limit to be exceeded is taxable from the date of issue. The tax-exempt status of interest on other previously issued qualified small-issue bonds is not affected.

Legislative Background

Substantial modifications to the tax treatment of exempt small-issue industrial development bonds (IDBs) were made by the Tax Equity and Fiscal Responsibility Act of 1982. The 1982 Act also provided that the authority to issue exempt small-issue IDBs would sunset on December 31, 1986. The Tax Reform Act of 1986 extended the sunset date for issues of qualified small-issue bonds for manufacturing facilities and certain land or property for first-time farmers to December 31, 1988. The Technical and Miscellaneous Revenue Act of 1988 generally extended that sunset date to December 31, 1989. Current refundings of qualified small-issue bonds may be issued after December 31, 1989, provided that the refunding bonds (1) do not have a weighted average maturity in excess of the weighted average maturity of the refunded issue, (2) have a lower interest rate than the rate on the refunded bonds, and (3) are in an amount that does not exceed the outstanding amount of the refunded bonds.

8. Low-income housing tax credit (sec. 42 of the Code)

Present Law

A credit is allowed in annual installments over 10 years for qualifying low-income rental housing, which may be newly constructed, substantially rehabilitated, or newly acquired existing residential rental property. For buildings placed in service after 1987, the credit percentages are adjusted monthly for buildings placed in service to maintain a present value of the credit stream of 70 percent for qualified expenditures for most newly constructed and rehabilitated housing. In the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies (including tax-exempt bonds), monthly adjustments are made to maintain a 30 percent present value for the credit.

The credit amount is based on the qualified basis of the housing units serving the low-income tenants. A residential rental project qualifies for the low-income housing credit only if (1) 20 percent or more of the aggregate residential rental units are occupied by individuals with incomes of 50 percent or less of area median income, as adjusted for family size, or (2) 40 percent or more of the aggregate residential rental units in the project are occupied by individuals with incomes of 60 percent or less of area median income, as adjusted for family size. Rents charged to families in units on which a credit is claimed may not exceed 30 percent of the applicable income qualifying as "low," adjusted for family size. If property on which a low-income housing credit is claimed ceases to qualify as low-income rental housing or is disposed of before the end of a 15-year credit compliance period, a portion of the credit may be recaptured.

Credit allocation is granted by State or local government credit authorities subject to an annual limitation ($1.25 per resident) for each State. In order for a building to be a qualified low-income building, the building owner must receive a credit allocation from the appropriate credit authority, unless the property is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. A building must be placed in service in the year in which a credit allocation is received from the credit authority or in either of the succeeding two years provided that, by the end of the year in which the credit allocation is made, the taxpayer's basis (land and depreciable basis) in the project of which the building is a part is more than 10 percent of the taxpayer's reasonably expected basis in such project.

Legislative Background

The low-income housing credit was enacted by the Tax Reform Act of 1986 with a sunset date of December 31, 1989.

9. Deductibility of health insurance costs of self-employed individuals (sec. 162(l) of the Code)

Present Law

Under present law, an employer's contribution to a plan providing accident or health coverage is excludable from an employee's income (sec. 106). No equivalent exclusion is provided for self-employed individuals (i.e., sole proprietors or partners in a partnership).

However, present law provides a deduction for 25 percent of the amounts paid for health insurance for a taxable year on behalf of a self-employed individual and the individual's spouse and dependents. This deduction is allowable in calculating adjusted gross income. A self-employed individual is an individual who has earned income for the taxable year (sec. 401(c)(1)). However, no deduction is allowable to the extent the deduction exceeds the self-employed individual's earned income for the taxable year. In addition, no deduction is allowable for any taxable year in which the self-employed individual is eligible to participate (on a subsidized basis) in a health plan of an employer of the self-employed individual (or of such individual's spouse).

The deduction is allowable if the nondiscrimination requirements applicable to employer-provided accident and health plans (sec. 89) are satisfied with respect to the plan for which the 25-percent deduction is allowable.

The amount deductible under this provision is not taken into account in computing net earnings from self-employment (sec. 1402(a)). Therefore, the amounts deductible under this provision do not reduce the income base for the self-employed individual's social security tax.

Legislative Background

The 25-percent deduction for the health insurance costs of self-employed individuals was enacted on a temporary basis by the Tax Reform Act of 1986 (for taxable years beginning before January 1, 1990). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988.

10. ESOP exception to additional tax on early withdrawals from qualified retirement plans (sec. 72(t) of the Code)

Present Law

Under present law, an additional 10-percent income tax applies to early withdrawals from a qualified retirement plan. However, certain distributions from an employee stock ownership plan (ESOP) or a tax credit ESOP are exempt from the additional income tax. This exception is available to the extent that the distributions are attributable to assets that have been invested, at all times, in employer securities (as defined in sec. 409(l)) that satisfy certain requirements (secs. 409 and 401(a)(28)) for the 5-year period immediately preceding the plan year in which the distribution occurs.

Legislative Background

The 10-percent additional income tax on early withdrawals and the ESOP exception to the tax were enacted on a temporary basis by the Tax Reform Act of 1986 (through December 31, 1989). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988.

11. $2 million exclusion from generation-skipping transfer tax (sec. 1433(b)(3) of the Tax Reform Act of 1986)

Present Law

A generation-skipping transfer tax is generally imposed on transfers by gift or bequest to grandchildren. Certain transfers aggregating less than $2 million made to grandchildren before January 1, 1990 are excluded from the tax.

Legislative Background

The $2 million exclusion was enacted in the Tax Reform Act of 1986.

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Prepared Statement of Senator Rudy Boschwitz

Mr. Chairman, I want to thank you and the members of your committee for allowing me to appear before you this morning to discuss an issue of great importance to the economic future of this country. As many of my colleagues know, I have long been a proponent of encouraging capital investment by permitting investors who invest for the long term to receive a partial exclusion from ordinary tax rates on the gains they realize. Although I strongly support the Tax Reform Act of 1986, I fought hard to retain pre-1986 capital gains tax treatment during debate on the bill.

When tax reform passed with the increase in capital gains tax rates intact, I began working immediately to overturn this particular result by introducing legislation to have the capital gains exclusion restored. A bill I introduced in the 100th Congress and again in the 101st Congress provides a two-tiered approach to gains taxation. The capital gain on qualified assets held for at least one year would be allowed a 40% exclusion from taxable income; the gain on those assets held for three years or more would benefit from a 60% exclusion.

Last year, I also organized the capital gains coalition here in the Senate. Currently, there are 16 Senators who have joined the coalition, and I expect our ranks to swell now that the debate on this vital issue has commenced in earnest.

Mr. Chairman, the United States currently has one of the most anti-capital investment tax systems in the free world. As has been discussed in previous debates on this subject, many of our foreign competitors have capital gains tax rates radically lower than ours. The maximum tax rate on capital gains in Canada is 17.51%; in france it's 16%; and West Germany and Japan exempt long-term gains from taxation altogether. I would suggest to the committee that providing a capital gains tax structure which is consistent with worldwide standards is fundamental to our international competitiveness.

Mr. Chairman, now I would like to discuss an approach to the tax treatment of capital gains which I have supported for many years and which has also been advocated by our distinguished colleague from Colorado, Senator Armstrong. That approach is the indexation of capital gains. In my view, there is tremendous merit to the idea of indexing certain assets in the computation of capital gains taxes. It is grossly unfair when illusory profits created by inflation are taxed at ordinary rates.

Consider this typical Midwestern scenario: a hard-working, middle-income couple operates a small business or farm. They the property. Finally, after many years of hard work, they sell their business or farm that by any measure is modest. Inflation on their real estate and years of depreciation reduce their basis so that the sale results in a large gain. In that year they are among the rich and they love it. The next year they revert to middle-income status. In the interim, they have been taxed on their gain as though they were among the wealthy.

Or consider another scenario posed in a commentary by Howard Gleckman in the February 20 edition of Business Week, where an individual had purchased $1,000 of stock in 1960. Under current law, when that investor sells his stock in 1989 for $9,000, his taxable gain is $8,000. If the taxpayer is in the 33% tax bracket, he pays $2,428 in capital-gains taxes. Add to that the State tax, which in my State is 8 percent or another $640. Unfortunately, over the course of the holding period, inflation has eaten up all but $2,026 of his profit. So after tax, his investment actually brings him a net loss of $1,042. Mr. Chairman, the scenarios I have described are not unique. They are played out over and over again as the people we depend on to invest in America's long-term future are penalized by a tax policy which does not reflect economic reality. bear in mind that persistent inflation in the age of 4-5 percent is arelatively recent phenomena. In my view, we ought to be taxing real gains, not invisible gains caused by inflation. Because long-term gains are not currently indexed but constantly eroded by inflation, the tax is much higher on long-term gains than it is on short-term gains. There is an inherent disincentive to make long-term investments. Mr. Chairman, taking the necessary action to protect investors against the ravaging effects of inflation should be our foremost consideration in framing this debate.

Let me suggest that the best way to remove the effect of inflation on capital gains is to allow the tax base of eligible assets to be adjusted by the amount of inflation that has occurred since those assets were purchased. Assets eligible for indexing should include corporate stock and real property used in a trade or business.

Indexing is fair and rational. It is also neutral in that it doesn't open the floodgate for special interest groups to plead for exclusions which would redirect investment dollars toward certain categories of investments. It is therefore consistent with the principle underlying the 1986 tax act which eliminated the capital gains preference in order to have investors base their actions on economic soundness rather than tax avoidance. Mr. Chairman, the concept of indexing is not a new idea. It has had widespread support in Congress, having passed both the House and Senate in previous years. Rather than going through the complex process of creating incentives for investment, indexing gets at the issue by eliminating disincentives. It brings greater equity and fairness to the tax system while promoting domestic investment and international competitiveness it is a concept which I intend to pursue and I look forward to working with the members of this committee toward that end.

PREPARED STATEMENT OF SENATOR DALE BUMPERS

Mr. Chairman and members of the committee, I am delighted to be here today at this first hearing in the 101st Congress on capital gains legislation.

BIPARTISAN DEBATE

The capital gains debate has been described by many commentators as a partisan debate between President Bush and congressional Democrats. This is not the case.

The capital gains debate is a bipartisan debate.

There are Democrats in the Congress—and I am one of them—who believe that we should reduce capital gains taxes.

In the Senate there are fourteen Democratic members who are supporting a capital gains tax reduction Senators DeConcini, Dixon, Gore, Inouye, Sanford, Daschle, Heflin, Sasser, Dodd, Kerry, Burdick, Cranston, Shelby, and me.

There are only seven Senate Republicans sponsoring a capital gains bill—Senators Boschwitz, McClure, Symms, Cochran, Kasten, Garn and Lugar.

On February 7, 1989, I introduced S. 348, the venture capital gains act of 1989. S. 348 is cosponsored by more Members of the House or Senate than any other capital gains bill pending in the House or Senate.

Eleven Senate Democrats have joined me as cosponsors of S. 348, including Senator Daschle of this committee. In addition, Senator Boschwitz is a cosponsor and he serves as the chairman of the capital gains coalition in the Congress.

And, of course, Chairman Bentsen has indicated that he supports a reduction in capital gains taxes and he has organized this hearing.

I repeat and I emphasize—the capital gains debate is a bipartisan debate. Democrats are playing a constructive role, proposing alternatives and raising issues, not just opposing the President's proposal.

VENTURE CAPITAL GAINS LEGISLATION

S. 348, the venture capital gains act, proposes that we provide a modest tax incentive in favor of high-risk, long-term, growth-oriented investments in small business ventures.

I have described the bill and its rationale in my introduction statement of February 7, a copy of which is attached to this testimony, so let me just make a few key points about my proposal.

The venture capital gains legislation is different from the President's proposal in nine respects:

1. My bill applies only to investments in stock.
2. It applies only to investments in the stock issued by a small business venture.
3. It applies only to direct purchases of the stock from the small business issuing the stock.
4. It only applies to new investments. It does not apply to investments made before the incentive goes into effect.
5. It requires a four year holding period.
6. It grants a 25% deduction and sets a 21% rate maximum capital gains tax rate. The President has proposed a 45% deduction and a 15% maximum gains rate.
7. The alternative minimum tax applies to the deducted gains. With the President's proposal it does not.
8. The deduction is available to corporate as well as to individual taxpayers. The President's proposal applies only to individual taxpayers.
9. And, most important, I have received a favorable revenue estimate from Joint Committee on Taxation which finds that S. 348 loses a fraction as much revenue as the President's proposal.

Let me just comment on a few of the differences between the President's proposal and my venture capital gains legislation.

A. Small Business Capital

The availability of capital to start-up small business ventures has always been a major problem. The tax reform legislation of 1986 exacerbated the problem by putting a high premium on short-term, income-oriented investments.

Venture capitalists do provide capital to start-up ventures, but increasingly they are becoming involved with leveraged buy outs and other financial deals. They are more risk-averse than they used to be, partly as a result of the tax reform law and partly as a result of their experience with how risky start-up ventures can be.

There is no absence of investors who seem to be willing to invest in the established companies who stock is traded on the major stock exchanges. And they seem to be willing to make these investments despite the absence of any capital gains preference.

My question is why should we give these investors a tax break for something that they are already doing without any tax break?

What we need to do is give them an incentive to change their investment strategy to place a greater emphasis to high-risk, long-term, growth-oriented investments in small business ventures.

That's where we have the need. And that's were the incentive should be directed.

B. Retroactivity

The President's proposal gives a tax break for any investment, even investments made before the capital gains tax reduction goes into effect.

This means that it provides a tax break for investments that were made with no expectation that the investor would receive any capital gains preference.

To me this is an undeserved windfall.

My question is why should we reward investors for doing what they have already done without any expectation of a tax reward?

I think the reason for this feature of the President's proposal may be that the Treasury Department could not find any other way to make the revenue numbers show a revenue gain in the early years.

You see, if investors can cash in their old investments, they'll receive a huge windfall but they will also pay some tax. They will only pay this tax at the new 15% gains rate, not the 28% or 33% ordinary income rate, but they will pay some tax. I think the department found it necessary to induce this rush of revenue in order to find that it's proposal raises revenue in the first few years.

Treasury Secretary Brady has said that he will review the retroactivity issue and I have asked him in a March 7 letter to provide me with an estimate of the revenue impact of the President's proposal assuming that it is not retroactive. If it turns out that the only reason the President's proposal raises revenue in the first few years is because it confers a huge, and undeserved, tax windfall on investors, the department may have to go back to the drawing board.

The President presents his capital gains bill as an incentive for investment. It is ironic that the principal impact of the proposal in its first years would be to encourage investors to cash in their old investments.

S. 348 is prospective only and confers no windfall, but the Joint Tax Committee still finds that it loses a fraction as much revenue as the President's proposal. This is true because of the other limitations in S. 348, which I have mentioned.

C. Phase-in of Holding Period

S. 348 requires a four year holding period for any investment that qualifies for the tax incentive. The President only requires a one year holding period for investments made during the first three years, a two year holding period for investments made in 1993 and 1994 and a three year holding period for investments made after 1994.

My question is why should we wait to put the longer holding period into effect?

If we want to encourage long-term investments, why should we start out by encouraging shorter-term investments?

I don't understand the logic of phasing in the longer holding period.

There is no fairness problem with immediately requiring a four year holding period. Any investor making a new investment would know what the holding period is and would not be surprised in any way if it starts at three years. And, if the investor made the investment with no expectation of any capital gains preference, he can hardly complain about a four year holding period.

Of course, if the holding period starts at four years, more reaping their windfall. This would reduce the rush of revenue to the Treasury Department.

Even if the tax preference applies only to new investments, there would be some slowing of gains realizations if the four year holding period goes into effect immediately.

For these reasons the Treasury may have found that if it immediately went to a three year holding period, it could not project a revenue gain. In fact, it does acknowledge that the President's proposal would lose $11.3 billion in 1996, right after the three year holding period goes into effect. So, the phase in of the holding period is obviously another case of revenue considerations driving tax policy.

But, again, S. 348 puts a four year holding period into effect immediately and it does not lose large amounts of revenue in the early years.

Again, the reason why this is true is that S. 348 is focused, targeted, and limited to venture capital investments, where a four year holding period is perfectly reasonable. Venture capital investors often could not find a market for their stock in the first three or four years. The one year holding period would be irrelevant to them.

D. 21% Gains Rate and Minimum Tax

S. 348 proposes that the maximum gains tax rate be set at 21%, which is less generous than the 15% maximum gains rate the President proposes.

I would like to offer investors a more powerful incentive and I found that some of my colleagues would not cosponsor S. 348 because they thought that it did not provide a strong enough incentive.

I chose 21% as the maximum gains rate for two reasons.

First, under S. 348 the alternative minimum tax applies. So, if S. 348 were to give investors a 15% gains rate, much of the benefits of that rate would be recaptured by the minimum tax, where the rate is 21%. The interplay of the gains rate and the minimum tax would amount to a zero sum game for the investors.

I would be very surprised if the congress would reestablish a differential for capital gains taxes without applying the minimum tax. The minimum tax applied to capital gains before the tax reform law. The principal argument being raised against restoring the capital gains tax preference is that it would principally benefit the wealthy.

S. 348 meets this fairness argument by applying the minimum tax.

And when I applied the minimum tax, the 21% maximum gains rate became the logical gains rate as well.

Second, a 15% maximum gains rate would lose more revenue than a 21% maximum gains rate.

I have asked the Joint Committee on Taxation to give me revenue estimates of S. 348 assuming that it sets a 19%, a 17% and a 15% maximum gains rate and assuming that the minimum tax does not apply.

When I receive these estimates I will reevaluate the provisions in S. 348. As I said, I would like to provide a more powerful incentive for venture capital investments if it is fiscally responsible and fair to do so.

E. Revenue Estimate

I already have obtained a revenue estimate from the Joint Committee on Taxation on S. 348 as it was introduced.

The committee gave me this estimate on September 18, 1987, based on the predecessor bill to S. 348, S. 931, which I introduced on April 7, 1987. The capital gains tax incentive provided in S. 931 was available only for companies with $10 million in paid in capital and the committee found that it would lose only $40 million in the first five years. I asked the committee how high this threshold might be raised and not lose $500 million in revenue and the committee said that I could eliminate this threshold and not exceed a five year revenue loss of $500 million.

When I reintroduced the bill in this Congress I raised the threshold to $100 million in paid-in capital. This was the only change I made in the bill, so the revenue loss for S. 348 would be what the committee has found in its September 18, 1987, estimate, less than $500 million over five years. I have asked the joint committee to confirm this revenue estimate and trust that it will again find that S. 348 is a fiscally responsible bill.

As you know the joint committee found that the President' s proposal would lose $24 billion in revenue in its first six years as law. So, if the President's proposal is sometimes referred to as the "15% solution," then maybe S. 348 should be referred to as the "2% solution"—2% as much revenue loss.

JOINT TAX STUDIES

I have asked the Joint Committee on Taxation to prepare three other studies for me and I hope to receive them shortly.

The first is on the interplay between the gains rate and the minimum tax. I have asked the committee to quantify the extent to which there is a zero sum game between the gains rate and the minimum tax. The second is on the distribution of benefits by income class for the President's proposal and S. 348. fairness is a key issue with the capital gains tax and I want to know how the two proposals compare.

And third, I have asked the committee to try to determine to what extent the President's proposal and S. 348 simply reward investors for doing what they are inclined to do without any tax preference. If we are looking at tax "incentives," we should know how much new activity of the desired type we expect to generate.

POLITICAL REALITY

S. 348 is a realistic capital gains bill. I didn't run for President and S. 348 is not a campaign-type proposal.

I am trying to legislate, not to make everyone happy.

S. 348 doesn't overpromise. It doesn't promise that you can "have it all." It isn't fancy.

It is focused. It is a bill we need and it is a bill we can afford.

I do not challenge the revenue estimates of the joint committee. I do not have to do that. I voted against "supply-side" economics in 1981 and it was one of the best votes I ever cast. I don't rely on magic to argue that we can cut tax rates and generate more revenue. S. 348 does lose some revenue, but it's a manageable amount.

My bill is prospective only and confers no windfall on past investments.

It rewards capital formation, not shuffling of assets among investors.

It is fair because the minimum tax applies.

In my view, the sooner the President and his "supply-side" supporters begin to focus on these issues, the sooner we can have a real debate on capital gains taxes here in the Congress.

Finally, I am trying to turn this debate into a bipartisan debate, with Democrats speaking out in favor of capital gains tax reductions, instead of just opposing the President's proposal.

Enclosure

COMPARISON OF CAPITAL GAINS PROPOSALS

	PRESIDENT BUSH	SEN. BUMPERS (S. 348)
MAXIMUM TAX RATE:	15%	21%
EXCLUSION ON GAIN:	45%	25%
HOLDING PERIOD:	1 YEAR UNTIL 1992, 2 YEARS IN 1993-1994 AND 3 YEARS AFTER 1994	4 YEARS -- FAVORS LONG-TERM INVESTMENTS
INVSTMTS. COVERED:	MANY CAPITAL ASSETS	STOCK OF SMALL BUSINESS ($100 MILLION PAID-IN-CAPITAL)
CAPITAL FORMATION:	COVERS SECONDARY MARKET TRADING	COVERS ONLY DIRECT INVESTMENTS THAT PUT CAPITAL IN HANDS OF ENTREPRENEURS
TAXPAYERS:	INDIVIDUAL	INDIVIDUAL AND CORPORATE
WINDFALL:	RETROACTIVE TO PAST INVESTMENTS, CONFERS HUGE WINDFALL	ONLY APPLIES TO NEW INVESTMENTS, NO WINDFALL
MINIMUM TAX APPLY:	NO	YES, ENSURING FAIRNESS
REV. LOSS:	$24 BILLION OVER SIX YEARS: JOINT TAX COMM.	LESS THAN $500 MILLION OVER FIVE YEARS: JOINT TAX COMM. (MINIMAL COST TO TREASURY UNTIL 1993 DUE TO FOUR YEAR HOLDING PERIOD)

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Senate

TUESDAY, FEBRUARY 7, 1989

(Legislative day of Tuesday, January 3, 1989)

S 1214

INTRODUCTION OF BILLS AND JOINT RESOLUTIONS

The following bills and joint resolutions were introduced, read the first and second time by unanimous consent, and referred as indicated:

By Mr. BUMPERS (for himself, Mr. DECONCINI, Mr. DIXON, Mr. GORE, Mr. INOUYE, Mr. SANFORD, Mr. DASCHLE, Mr. HEFLIN, Mr. SASSER, Mr. DODD, Mr. KERRY, Mr. BURDICK, and Mr. BOSCHWITZ):

S. 348. A bill to amend the Internal Revenue Code of 1986 to restore a capital gains tax differential for small business stock held more than 4 years; to the Committee on Finance.

S 1215

STATEMENTS ON INTRODUCED BILLS AND JOINT RESOLUTIONS

By Mr. BUMPERS (for himself, Mr. DECONCINI, Mr. DIXON, Mr. GORE, Mr. INOUYE, Mr. SANFORD, Mr. DASCHLE, Mr. HEFLIN, Mr. SASSER, Mr. DODD,

Mr. KERRY, Mr. BURDICK, and Mr. BOSCHWITZ):

S. 348. A bill to amend the Internal Revenue Code of 1986 to restore a capital gains tax differential for small business stock held for more than 4 years; to the Committee on Finance.

VENTURE CAPITAL GAINS ACT

● Mr. BUMPERS. Mr. President, today I am reintroducing legislation to provide a modest tax incentive in favor of high-risk long-term investments in America's future.

It has never been clearer that Americans need to fight for our economic prosperity and independence. We find ourselves in an international competition of great intensity and we are losing on many fronts.

There is a developing consensus that American investors and businessmen focus too much on short-term gains in income and neglect long-term investments in economic growth. The values that are associated with the stereotype of a yuppie and infecting our business community and our economic prosperity as a nation will suffer as a result.

Today we underinvest in new business ventures, in research and development, in plant and equipment, and in training. When we underinvest, we put our future at risk, we live for the moment, and we ignore the piper's song.

Increasingly we rely on financial wizards and lawyers to camouflage the fact that our economic foundations are eroding.

The legislation I reintroduce today addresses this issue by giving investors an incentive to become venture capitalists, to take risks, to invest for the long-term, and to seek the gains which come from economic growth.

My legislation will encourage investors to take risks on new ideas and new technologies, to give entrepreneurs the capital they need to fund the business ventures of tomorrow, and to wait for long-term gain on these investments.

I am delighted that Senators DECONCINI, DIXON, GORE, INOUYE, SANFORD, DASCHLE, HEFLIN, SASSER, DODD, KERRY, BURDICK, and BOSCHWITZ have agreed to be original cosponsors of this legislation. I hope to have more cosponsors as the capital gains debate becomes more focused.

It is clear from this list of cosponsors that the capital gains issue is a bipartisan issue in the Congress. Senate Democrats are just as interested in the capital gains issue as are Republicans. Senate Democrats want to debate the capital gains issue on the merits and to join in fashioning a reasonable and effective incentive for capital formation.

I look forward to working with my cosponsors and with the members of the Senate Finance Committee on the capital gains issue.

HISTORY OF VENTURE CAPITAL GAINS LEGISLATION

While we were considering the Tax Reform legislation in 1986 I expressed my concern about the repeal of the capital gains tax preference. My concern then and my concern now is that small business ventures would suffer most if the capital gains preference was repealed and this has proven to be true.

During consideration of the tax reform law, the Small Business Committee held a hearing on this issue and we heard from many experts about the adverse consequences of repealing the capital gains tax. ("The Elimination of the Capital Gains Differential for Individuals and Its Impact on Small Business Capital Formation," hearings before the Senate Small Business Committee, June 4, 1986.) We heard from venture capitalists who warned that repealing the capital gains preference would reduce the inclination of investors to make high-risk, long-term, growth-oriented investments.

The witnesses said that the problem with the tax reform law would be that it would place a premium on low-risk, short-term, income-producing investments. With the elimination of the capital gains tax preference, there would no longer be any reason for a taxpayer to hold onto an investment even for 6 months, the old holding period required for capital gains investments.

Of course, the Congress ignored these warnings, adopted the tax reform law, and the capital gains tax preference was eliminated.

To remedy the flaw in the tax reform law, in April of 1987 I introduced S. 931, the Small Business Capital Formation Act of 1987. (133 Congressional Record S4728-4732, April 7, 1987.) The bill I introduce today is the same bill, with some minor technical refinements.

VENTURE CAPITAL GAINS COMPARED TO PRESIDENT'S CAMPAIGN PROPOSAL

I introduced S. 931 long before then-Vice President George Bush advanced his own capital gains proposal. We are now awaiting the details on his proposal, which may differ from the capital gains proposal he described during the campaign. But it is helpful in describing the bill I am introducing today to compare it to the capital gains proposal the President advocated during the campaign.

TERMS OF CAPITAL GAINS PROPOSALS

The President and I agree on one point about capital gains taxes. We agree that the repeal of the capital gains tax preference in the tax reform law was ill-considered. But there are then many differences in our approaches to restoring a capital gains preference.

The President's capital gains proposal, as described during the campaign, is sweeping.

First, he proposed during the campaign that the maximum tax rate on capital gains income be reduced from 33 to 15 percent. This is a 55 percent reduction in the maximum tax rate. This makes the 25 percent "supply side" tax cut cut in 1981 look modest by comparison.

Second, this dramatic tax break apparently would be available for the sale or exchange of any capital asset.

The term "capital asset" is a term of art in the tax law, but it includes virtually everything—type of property you own and use for personal purposes or investment.

It includes corporate stock, commodities and futures contracts, shares in a partnership, a dwelling owned and occupied by you and your family, household furnishings, a car used for pleasure purposes and commuting, coin or stamp collections, gems and jewelry, gold, silver, and any other metal.

It includes property used in trade or business, an invention, good will, a franchise, trademark or trade name, livestock, and timber, domestic iron ore and coal may all be capital assets.

I have commissioned a memorandum from the Congressional Research Service which outlines the range of assets which qualify as capital assets and it an expansive list. (Memorandum of Greg Esenwein, CRS, August 3, 1988.) When you review the list, in many cases it becomes difficult to justify providing preferential tax benefits. It is incumbent on any advocate for preferential tax treatment to explain why it is in the national interest to reduce the tax burden for taxpayers who make certain investments and I do not think that this is possible for investments in many of the assets which qualify as capital assets.

Third, the President indicated during the campaign that to qualify for capital gains tax treatment, the investment would have to be held for 1 year. On January 1, 1988, the holding period on capital gains reverted from 6 months to 1 year and the President would not propose that the 6-month holding period previously in effect be restored.

The 1-year holding period is hardly enough to encourage the patient capital that American firms need to grow and prosper. It's better than a zero holding period, but it's hardly enough to encourage long-term, high-risk investments in America's future.

Finally, it is not clear whether the President intends for the alternative minimum tax [AMT] to apply. The AMT would not apply unless the tax law is amended to include capital gains in the list of preference items. Indirect sources indicate that Bush would not apply the AMT to the new capital gains preference, but no decision on this issue apparently has been made.

This means that high income taxpayers would claim capital gains income and avoid paying their fair share in taxes. The minimum tax is one of the most important reforms of the tax reform law and the President's campaign proposal would undermine its application and effectiveness.

My capital gains bill—S. 931—and the bill I am introducing today propose a much narrower capital gains tax preference, one that is targeted at high-risk, long-term, growth-oriented investments.

First, I propose that the maximum tax rate on capital gains income be 21 percent. This represents a 36-percent reduction in the tax rates which apply to capital gains.

Second, this tax break would be available only for investments in corporate stock. It is not available for investments in any other capital asset.

Third, these investments in corporate stock must be direct investments in corporate stock; that is, purchases of stock directly from the corporation as distinct from purchases of stock sold by another investor, trading in the secondary market.

Fourth, the stock must have been issued by a small business with less than $100 million in paid-in capital. I will discuss this limitation further in a minute.

Fifth, the stock which is purchased must be held for a minimum of 4 years.

And finally, any gain on the stock is explicitly included as a preference item in the alternative minimum tax.

S. 931 and the bill I introduce today are directed at the investments typically made by entrepreneurs and venture capitalists. These are risky, long-term investments in startup ventures. These are the investments which entrepeneurs make when they start a new business. These are the investments which venture capitalists make when they back an entrepreneur with seed capital.

I made this point at some length when the Senate debated the amendment offered by Senator ARMSTRONG to the Senate budget resolution on April 14, 1988. I argued then against indexing the basis for capital assets and in favor of a targeted capital gains exclusion. I emphasized then that capital gains should be for entrepeneurs. (133 Congressional Record S3959-3960, April 14, 1988.)

The President's capital gains incentive is available for much less risky, much shorter-term investments in a wide variety of assets which have nothing to do with growth or job creation or the competitiveness of U.S. industries.

Why should we encourage investments in vacation homes or antique cars? I see no public policy rationale for a capital gains tax preference for either type of investment.

My bill is fairer to middle-income taxpayers. It limits the benefits which wealthy taxpayers can reap from the preference and the President's proposal does not.

The differences between the President's campaign proposal and my own are fundamental. They go to the question of what type of investments we should encourage. They concern the value of the incentive we should provide and who should receive the incentive.

These differences are issue of policy, but they are also issues which go to our values and priorities.

COMPARISON OF REVENUE IMPACT

Any consideration of a capital gains tax preference must focus first on the potential impact of such a preference on Government revenue. The merits of the issue are not open for serious debate if the revenue impact is severe.

The President's campaign proposal: President Bush asserted many times during the campaign that his proposal "would not cost the Government money." Rather, "it would gain additional revenue by stimulating growth." He repeated this claim at his first press conference last week. He states that this assertion is substantiated by the effect of the 1978 reduction in tax rates on capital gains—the Hansen-Steiger amendment—and by the research of Prof. Martin Feldstein and NBER researcher Lawrence Lindsey.

The Joint Committee on Taxation, however, has ruled in a response to an inquiry from Congressman BILL ARCHER that a 15-percent tax rate on capital gains would reduce Government revenue by $8.5 billion in 1990, $15 billion in 1991, and $17.1 billion in 1992. (Letter of David Brockway to Congressman ARCHER of November 8, 1987). The total 3-year revenue loss is projected to be $40.6 billion.

Similarly, the Congressional Budget Office has stated that a 15-percent rate would probably reduce Government revenue by between $3.9 and $7.8 billion per year.

Finally, a recent Congressional Research Service report indicates that instituting a capital gains tax preference may have a negative impact on Government revenue in the long run even if it has a positive impact in the short term.

In January 1987 the Treasury Department estimated that the increase in the capital gains tax rate in the Tax Reform legislation (from 20 percent to 28-33 percent) would increase Government revenue by $21.8 billion over 5 years. The Federal Government already has received a $10 to $15 billion revenue bonus at the end of 1986 when taxpayers rushed to sell assets to take advantage of the then-still-applicable 20 percent maximum capital gains tax rate.

All of these estimates are controversial. There are more recent studies by the Treasury Department which indicate that some of the methodology in its earlier studies are not appropriate. These recent studies have been attacked by critics of the capital gains exclusion.

I am not sure that the revenue loss estimates of the Joint Committee and Treasury Department are accurate. Indeed, I am not even sure that they are reasonable. But, I do know several things.

These estimates seem to have been prepared in good faith by professionals. There is broad agreement among the Government officials who are preparing estimates.

Most important, these estimates are not static estimates. In each case, they find that a reduction in capital gains tax rates does encourage investors in capital assets to sell their assets, generating taxable income. They do not find that this increase in asset sales—in tax parlance these sales are referred to as "realizations"—are as great as others would find. They find that the rate of realizations increases, but they do not find that the increased rate is enough to offset the loss in revenue due to a lower tax rate.

Whether or not one agrees with its estimates, it is clear that the Joint Committee would find that the President's campaign proposal would lose many billions of dollars in revenue, perhaps tens of billions of revenue, if enacted into law. The Joint Committee does not accept the arguments of Mr. Feldstein or Mr. Lindsey.

More interesting, the Treasury Department of the Reagan-Bush administration still does not agree with the President's conclusion. As I have said, the Department is reviewing its position but it has not as yet changed its position.

There is good reason for all of us to be skeptical of any proposal which argues that a reduction in tax rates leads to an increase in revenue.

The 1981 "supply side" tax cut also was supposed to have a minimal impact on revenues because it was supposed to stimulate economic activity, but the official estimate of its impact on revenue—an estimate contained in President Reagan's own budget—is that it will reduce Government revenue by $290.9 billion this year alone.

Of course, whether or not one agrees with them, the revenue estimates of the Joint Committee are the only estimates used in the House and Senate and they alone determines whether the point of order under the Gramm-Rudman-Hollings law—as to whether a proposal is "deficit neutral"—applies.

This means that any proposal to reduce capital gains tax rates to 15 percent would have to be paid for by an equal amount of additional revenue from some other source or an equal amount of reductions in spending. The final result must not increase the deficit and the Joint Committee's determination on whether a proposal is deficit neutral is binding.

Revenue impact of venture capital gains bill: The revenue estimates for the President's campaign proposal contrast sharply with those for S. 931 and the bill I introduce today.

S. 931 differs from the bill I introduce today in that it would provide an incentive only for stock issued by companies with $10 million or less in paid-in capital. The venture capital gains bill would be available if the paid-in capital is less than $100 million. This makes very little difference in the revenue impact of the bill.

In 1987, I obtained an official revenue estimate from the Joint Committee on the revenue impact of S. 931. The Joint Committee finds that S. 931 would lose $24 million—that is million, not billion—in revenue in 1992, the first year after the 4-year holding period has run. Over a 3-year period it would lose $40 million. (Letter of Mr. David H. Brockway, September 18, 1987.)

This revenue estimate was so low that I asked the Joint Committee by how much the $10 million limitation in S. 931 could be raised—to apply the tax break to investments in larger businesses—while holding the revenue loss in 1992 to less than $500 million. The Joint Committee has told me that the $10 million limitation could be "removed altogether" and the revenue loss would be less than $500 million in 1992. The committee did not provide a specific revenue loss figure for the bill if the $10 million limitation is removed or raised to a given figure. (Letter of Mr. David H. Brockway, September 18, 1987.)

After obtaining this estimate, I consulted at length with representatives of the National Venture Capital Association and the National Small Business Investment Company Association to determine by how much we should raise the $10 million limitation. In these discussions I insisted that the aim must continue to be to target the capital gains break to smaller businesses because this is central to the concept of the bill. Based on these consultations, I have determined that the threshold should be raised from $10 million to $100 million.

The venture capital gains bill remains identical to S. 931 on the other key issues, the 21-percent maximum rate, the limitation to direct investments, the 4-year holding period, and the application of the minimum tax. Each of these limitations is fundamental to the purpose and rationale of S. 931 and to the current bill.

So, with the $10 million limitation, S. 931 it lost one one-thousandth as much revenue as the President's campaign proposal, $40 million versus $40 billion. With the $100 million limitation, the venture capital gains bill loses one-eightieth as much revenue as the President's campaign proposal, $500 million versus $40 billion.

These revenue estimates on S. 931 and the current bill show that the 21 percent maximum rate, the limitation to direct investments, the limitation to purchases of stock, the 4-year holding period, and the application of the minimum tax are powerful constraints on the revenue loss for the bill.

They show that the 15 percent maximum rate, the absence of limitations on the type of investment, the 1-year holding period, and the exemption from the minimum tax are extremely generous and open the floodgates to lose Government revenue.

In terms of the budget deficit, the venture capital gains bill is responsible and the President's campaign proposal is not.

During the past 2 years I have suggested one way to finance the revenue loss which comes from enactment of my capital gains bill. On September 30, 1987, I wrote to the Members of the House Ways and Means and Senate Finance Committees stating that if the committees raised income tax rates for the 1987 reconciliation bill, there could well be enough revenue generated to adopt S. 931. If income tax rates were raised, it is likely that the committees would at least have retained the 33-percent maximum tax rate on capital gains. I suggested that the committees should move to lower capital gains tax rates along the lines suggested in S. 931.

Of course, the two committees chose not to raise income taxes rates so they never faced the issue of how to adjust capital gains tax rates.

We did debate this issue in late 1987 in the Senate when we debated the legislation to implement the deficit reduction agreement following the October stock market crash. During that debate Senator KASSEBAUM and I proposed an amendment which would have frozen most spending and frozen tax rates at their 1987 "transition" levels. This freeze on tax rates would have preserved the differential in tax rates between capital gains and ordinary income. The Kassebaum amendment was defeated.

This year we may again debate tax rates. The 33-percent recapture rate is an anomaly. High income individuals pay a top tax rate of 28 percent. Taxpayers with less income pay a top tax rate of 33 percent. In short, our tax system is regressive for high income individuals. This tax rate structure makes no sense. If we turn this 33 percent recapture tax rate into a flat bracket, we should focus on the capital gains issue.

WINDFALL VERSUS INCENTIVE

The capital gains tax is a tax incentive. Its purpose is to induce or encourage taxpayers to engage in certain behavior which we in the Congress believe is in the national interest. We should only provide a tax incentivbe to taxpayers if we believe that providing the incentive will induce or encourage taxpayers to engage in that behavior and if we believe that taxpayers would not otherwise engage in that behavior.

A tax incentive merely creates a windfall if it rewards taxpayers for doing that which they would do without the incentive. Of course, some taxpayers already make investments in capital assets or in the stock of startup small businesses and their investments would now be rewarded with a tax subsidy. For these investors the capital gains tax preference confers a windfall and is not responsible for encouraging these taxpayers to make these investments.

It is clear that the President's campaign proposal would confer a much greater windfall on taxpayers than would the venture capital gains bill. There is no capital gains tax preference now and millions and millions of investors are buying capital assets and holding them for a year. There are very few taxpayers who invest in startup small businesses and hold the investment for 4 years. This is part of the reason why the revenue loss for my bill is so much less than for the "15 percent solution."

We should not give away tax subsidies unless taxpayers have to work for them, to do something that is riskier with their investment dollars. The President's campaign proposal does not set high enough standards for the quid pro quo for the subsidy. The venture capital goods bill does.

I have requested that the Joint Committee on Taxation to attempt to determine the degree of windfall which is conferred by the President's campaign proposal and the venture capital gains bill. I am awaiting its report. I am not sure the Joint Committee has ever been asked to prepare such a report before but its report will be very interesting to review.

DIRECT INVESTMENTS VERSUS TRADING

"Capital formation" is the rallying cry for all those interested in providing tax incentives for investment.

The venture capital gains bill literally forms new capital in the sense that it applies only to the initial investments in new issues of stock issued by small companies. My bill puts new capital in the hands of entrepreneurs to use in founding or expanding a business. The capital is formed for the persons who need it, the entrepreneur.

The venture capital gains bill does not apply to the trading of a stock in the secondary market, which does not raise any additional capital for the company which issued the stock in the first place. Once a business has issued and sold its stock, it has obtained the capital it needs from the investors. No new capital is formed when stock is traded on the secondary market.

If trading of that stock increases the price of the stock, the business can obtain more capital when it issues additional stock. The business wants the stock price to rise so that it can raise more capital if it issues additional stock and so that an investor does not try to take over the company by buying a controlling share of the stock. But the immediate beneficiaries of stock trading in the secondary market are investors and brokerage houses, not the business whose stock is traded.

By providing a tax incentive only for direct investments in stock, the venture capital gains bill ensures that the business which issues the stock—and the entrepreneurs who run the business—should be able to obtain a higher price for the stock it issues. This means the business and the entrepreneurs will have more capital to work with in building the business.

This focus on direct investments may have a positive impact on initial public offerings of stock—and subsequent issues of stock by the businesses until the $100 million or other limitation comes into play. These initial public offerings are the riskiest undertakings for an entrepreneur, but going public is the only way many growth-oriented small businesses can raise the capital they need to grow.

The venture capital gains bill forms new capital and puts it in the hands of entrepreneurs. The President's campaign proposal forms very little new capital and mostly shifts it around among investors. My proposal rewards wise investments in smart entrepreneurs, while the President's rewards speculation about the value of existing stock.

STOCK PURCHASES VERSUS OTHER INVESTMENTS

The old capital gains tax preference applied to many types of investments other than investments in corporate stock, including many investments which have nothing to do with competitiveness or other macroeconomic issues. It applied to investments in vintage cars, antiques, gold coins, paintings, and gems. It also applied to investments in real estate.

The venture capital gains bill applies only to investments in corproate stock because small businesses rely on the equity market to obtain patient capital. Most small businesses cannot afford to pay the carrying costs on debt. As a matter of public policy, we should encourage growth in the equity markets, not the debt markets. This public policy explains the elimination of the tax deduction for consumer interest.

The venture capital gains bill focuses on investments which will help American compete in international trade. There is no rationale for encouraging investments in collectibles. Similarly, there is little need to encourage additional investments in real estate. Investments in seed capital for entrepreneurs is what is needed for American to be competitive.

REAL RISK OF INVESTMENT

The venture capital gains bill provides a tax break to investments in the stock of small businesses because there is real risk in these investments. Small businesses can and do fail. In fact, venture capitalists have a rule of thumb that only one or two of ten investments will pay off well in the long run.

Companies whose stock trades on the New York Stock Exchange rarely fail. They pay dividends regularly. The price of the stock may rise or fall, but an investor rarely risks losing everything he or she has invested.

Investors in the initial offering of stock take a particular risk because it is difficult to know how much the stock will sell for in the secondary market. The initial price of stock may bear little relationship to the value that other investors will place on that stock in the secondary market. The price of initial public offerings may rise or fall substantially the first day the stock is traded in the secondary market. In fact, there may be no secondary market for the stock because it is not possible to know how much the stock is worth.

Often investments in startup companies are made before the company has manufactured or marketed any products. The investments provide research funds for the company to discover a new product or to begin manufacturing that product. At this point in the life of the company, it is very difficult to know how profitable the company will be and it may be many years before it turns any profit at all. Startup companies must reinvest their income in further reseach, manufacturing facilities or mass marketing. This may delay their ability to pay out dividends.

This is why there is a need for a tax incentive to encourage these investments. These investments do involve real and substantial risk. These are investments which investors are reluctant to make, but these are investments which must be made if we are to compete in international markets.

ENTREPRENEURS AND EMPLOYEES

The venture capital gains bill applies to stock purchases by any investor, including the entrepreneur who founds a company and employees who have stock purchase plans. It does not simply apply to outside investors who purchase the stock.

It is a relatively simple matter for an entrepreneur to issue stock to himself. It may be more difficult to determine the market value of that stock than it is to determine the value of stock sold to outside investors and the burden is on the taxpayer to substantiate his or her claims about the basis value of the stock.

For many small businesses, the value of the companies they found is their principal source of retirement savings.

FOUR YEAR HOLDING PERIOD

The four year holding period ensures that investors do not expect that the small businesses in which they invest will quickly generate income. The venture capital gains bill rewards investors who seek long-term growth, not short-term returns. It seeks to lengthen the time-horizon of both the companies which issue the stock and the investors who buy it.

This four year holding period is another element of the risk which is rewarded by my bill. There is inherently less risk in a shorter term investment. The longer the taxpayer must hold the investment to gain the tax benefits, the greater are the risks which the taxpayer must take and the greater is the justification for the tax benefit.

The purpose of the venture capital gains bill is to encourage risk taking.

The holding period involves risk, the emphasis on direct investment involves risk, and the limitation to the stock of small businesses involves risk.

ALTERNATIVE MINIMUM TAX

I have already said that the venture capital gains bill sets the maximum tax rate on capital gains at 21 percent and that the alternative minimum tax applies. These two provisions are directly related to one another.

The maximum tax rate of 21 percent on captial gains in S. 931 is the same as the tax rate under the minimum tax in the tax reform law. I considered setting a maximum tax rate of less than 21 percent, but it makes little sense to set the tax rate on capital gains lower than 21 percent if the minimum tax applies. If one sets a maximum tax rate on capital gains which is lower than 21 percent, the taxpayers who are subject to the minimum tax will still end up being taxed at the 21 percent rate under the minimum tax. It's a zero sum game for taxpayers who are subject to the minimum tax.

I have requested that the Joint Committee on Taxation to analyze the relationship between a capital gains preference and the minimum tax. In a letter of June 26, 1988, Mr. Ron Pearlman of the joint committee has presented an exact formula which explains this relationship and in a letter of July 26 I have asked the joint committee to prepare an additional analysis of this issue.

No debate on the capital gains issue can avoid the minimum tax issue. It is inconceivable to me that Congress would restore a capital gains tax preference without applying the minimum tax. If I am correct in this judgment, it is hard to justify setting a maximum tax rate for capital gains of less than 21 percent.

PROGRESSIVITY AND FAIRNESS

The alternative minimum tax ensures that individuals cannot aggregate their tax preferences to reduce their marginal tax rate below 21 percent. This ensures that the venture capital gains bill will not undermine the progressivity and fairness of the tax system.

Many feel that the principal reason why the capital gains exclusion was repealed by the tax reform legislation was because a disproportionate amount of the benefits of the exclusion went to high-income individuals. When the Congress moved to drastically reduce tax rates, limiting the tax applicable to very high income individuals to 28 percent, it had no choice but to limit the tax reduction opportunities provided to these high income individuals by such tax preferences as the capital gains exclusion.

The elimination of the capital gains exclusion served this purpose and so did the adoption of the alternative minimum tax. The tax reform law did not eliminate all tax preferences. There are still ways for high income taxpayers to reduce their tax liability. The minimum tax seeks to ensure that we will never again have reports of multimillionaires paying no taxes.

The venture capital gains bill explicitly includes the tax benefits of the capital gains tax break as a preference item in the minimum tax to ensure that the bill does not adversely affect the progresssivity of the tax system. It will not return us to the time when there were scandals about wealthy individuals avoiding paying any Federal income tax.

I have requested that the Joint Committee on Taxation study this issue in some detail. (Letter of May 12, 1988.) I have specifically asked the committee to analyze the distribution of benefits from the venture capital gains bill and from the President's campaign proposal. I am sure that this study will find that the benefits conferred by my bill are much more evenly distributed and are concentrated with the highest income taxpayers.

EFFECT OF CAPITAL GAINS REPEAL

There are many differences between the venture capital gains bill and the President's campaign proposal. But, let me repeat again that the President and I agree that the repeal of the capital gains tax law was bad policy.

It is not possible as yet to determine precisely how the increase in the capital gains tax rates has affected capital investments generally, but there is evidence that it has hurt capital formation for small businesses. The evidence is very hard to evaluate because there are so many conflicting forces at work. For example, there have been major nontax developments such as the stock market crash which have crippled markets for initial public offerings.

We do know that traditionally small businesses have had more difficulty obtaining capital because investments in small businesses involve more risk and have less prospects for generating short-term income. The reports of the Small Business Administration and others provide extensive data on this problem.

We know that the tax reform law exacerbates this problem by reducing the tax penalty on ordinary income by reducing marginal tax rates. This fact, together with the elimination of the capital gains holding period, may well reduce the attractiveness to investors of long-term, growth-oriented, riskier investments, particularly those in startup small businesses. It may increase the attractiveness of short-term, income-oriented, safer investments. If this is true, the tax reform bill will hurt investments in small businesses, which need to reinvest all of their net income in the business to help it grow and prosper.

There is anecdotal evidence that the tax reform law is hurting capital formation for small businesses. Venture Magazine reported that "startups face trouble from venture capitalists, an imperiled SBIC program, and a higher capital gains tax." ("Desperate for Dollars," May 1988.) This article states that the problem arises from "simple arithmetic." When venture capitalists can get a fairly safe 35 percent to 50 percent on a leveraged buyout, why accept a potential 50 percent on a startup that carries more risk?" One venture capitalist said that "venture capitalists aren't looking for seedlings, they're looking for 12-inch tree trunks."

It is too much to expect that those of us who propose a capital gains tax preference will ever be able to precisely quantify what the tax reform law means for capital formation for the country or for small business. But, we have strong evidence that it has exacerbated a problem which small businesses always have had in obtaining sufficient capital to grow and prosper.

THE CAPITAL GAINS DEBATE

There are some who will oppose any capital gains tax no matter how targeted it may be. They will argue that the tax reform law should not be changed, particularly by restoring one of the principal tax preferences. They will argue that the beauty of the tax reform law is that it simplifies the tax code, eliminating distortions. They will argue that restoring any tax preferences would require raising the low tax rates, which would undo the principal benefit of the tax reform law.

I respect these arguments. They are arguments about principles. These arguments are made by some of the most responsible Members of the Congress. These are arguments which must be addressed by those of us who support restoring a capital gains tax preference.

The venture capital gains bill does recreate a capital gains tax break and that is controversial no matter what the limitations are in the proposal. The tax break I propose is limited and targeted and it may be much more palatable than the President's campaign proposal, but it does reopen the debate on capital gains and it may even reopen the debate on the tax reform law.

Many tax reform advocates long opposed the capital gains tax break and hailed its repeal. Statistics cited during the tax reform debate showed that the benefits of the capital gains tax break had gone largely to wealthy individuals. In addition, the 6-month holding period was indefensible.

It can be said that any move to recreate any tax break for capital gains undermines the tax reform legislation. The venture capital gains bill can be seen as a foot in the door for a much broader proposal like that of the Vice President. Reform advocates may not think this to be wise.

The critics of the capital gains preference can ask why the President would favor special tax treatment for investments in collectibles and real estate, why he favors a large differential in tax rates, why he favors the break for nondirect investments, why he favors a short holding period, and why he favors exempting the gains from the minimum tax. And, most important, they will ask why he is so unconcerned about the revenue impact of an across-the-board capital gains tax preference.

My proposal challenges the assumptions about capital gains by showing that there is a moderate, targeted, fiscally responsible alternative to the old-style capital gains exclusion. The criticisms which can be made of the President's campaign proposal do not apply to the venture capital gains bill.

My proposal focuses on entrepreneurs, employees of startup businesses, and venture capitalists—not on takeover artists, arbitragers, and margin accounts. It focuses on investments in businesses that might actually fail, not on trading of IBM stock. It provides capital to small businesses, which have been shown to be the principal source of new employment and innovation. It focuses on the future, not on the short term. It would not adversely affect the progressivity of the tax system.

If there is any rationale for restoring a capital gains tax incentive, and I think there is, the venture capital gains bill is the approach we should take.

It is the only fiscally responsible capital gains proposal being considered in the Congress.

It rewards real risk taking in growth-oriented small businesses.

It offsets the bias toward low-risk, income-oriented investments in the tax reform legislation.

It gives a preference only to investments which have a bearing on the competitiveness of the country.

It literally forms new capital, rather than simply encouraging trading of existing capital.

And it is fair to the middle income taxpayer.

These features of the venture capital gains bill do not meet every argument which the defenders of the tax reform law may raise. They want no changes in the tax reform law. They view it as a holy document. They see a problem with any changes because they fear that this will lead to a flood of changes.

When the arguments turn to the merits of the issue, the venture capital gains bill is a capital gains proposal which makes sense. It takes the debate on capital gains back to the basics, long-term risktaking.

I have great respect for the authors of the tax reform law. I did not agree with the repeal of the capital gains incentive, but I understand why it happened. I do not think that the tax reform law is perfect and cannot be improved. I look forward to debating the venture capital gains bill on the merits.

POLITICAL REALITY ON CAPITAL GAINS

I fear that the President's campaign proposal gives the opponents of a capital gains tax preference too many arguments.

His proposal is so lacking in focus, so indiscriminate and so irresponsible in its potential revenue impact, it discredits our efforts to debate this issue.

Two years after we have completely abolished the capital gains preference is too soon for anyone to be arguing that we should completely reverse course. This is shortsighted and politically unrealistic. Congress does not often completely reverse itself on any issue and it rarely does one on an issue which was thoroughly debated the first time.

The President apparently has learned nothing from the tax reform debate. One would think that he did not support the President's tax reform initiative. He does not see any legitimacy in the criticisms which were raised about the old capital gains tax. He wants to return to the old capital gains tax preference, with no changes, no rethinking of the issues, and no new concepts.

The President's campaign proposal makes it easy for the opponents of the capital gains tax preference. In fact, I believe that the President's proposal will delay the time when we will have a full-blown debate on the capital gains issue. It is too easy to defeat the President's proposal on a point of order. It is too easy to ridicule it. It is too hard to explain why we are providing an incentive for investments in vacation homes and antique cars.

There are some who will be beguilded with the President's campaign proposal. It's both flashy and simple. It promises a return to the good old days. It promises the combined benefits of the low tax reform rates and the old tax preferences. It promises that you can have it all.

The politics of this issue may turn out to be quite strange. I would think that the representatives of the securities industry would oppose the President's proposal because it restores the 1-year holding period. It prospers when investors trade stock, not when investors hold it. It fought for the 6-month holding period and it loves the zero holding period even more.

There are, however, investors who specialize in making long-term, high-risk investments, the venture capitalists. They know that the entrepreneurs they back cannot pay out any dividends. They know that some of these ventures fail. They know that the secondary market for their investments is weak. But, they take the risk because there can be tremendous rewards.

The natural constituency for the venture capital gains bill is the venture capital industry. In fashioning this bill I have worked closely with the National Venture Capital Association and the National Small Business Investment Company Association. These asociations can understand the rationale for a long holding period and for rewarding high-risk investments.

In fact, I woud argue that it is in the interest of the venture capitalist to oppose the President's campaign proposal. If the President's proposal were to be adopted—which I think is exceedingly unlikely—the primary beneficiary will be the securities industry, which specializes in shorter term, lower risk investments. The 1 year holding period will lead investors away from longer term, higher risk investments. It is even possible that the pool of venture capital investors may shrink. The President's proposal may discourage longer term, higher risk investments.

The tax reform law did eliminate many tax preferences. It did deregulate the tax system. This means that whatever tax incentives are left are even more powerful. There aren't many tax incentives left and those which remain are all the more attractive. If the President's campaign proposal were to be adopted, it will be the dominant tax issues for all investments. And, it is not focused on the type of investments made by venture capitalists.

On the other hand, if the venture capital gains bill is adopted, it will provide a powerful incentive that is tailor made for venture capital investments. If it is adopted, the pool of venture capital may increase. There will be an incentive for longer term, higher risk investments and perhaps a slight disincentive for shorter term, lower risk investment.

Indeed, the President's campaign proposal and the venture capital gains bill may have opposite effects. One helps the securities industry and one helps the venture capital industry. It is clear to me that these two industries cannot agree on one approach to the capital gains issue. Their interests are inconsistent. That's just a statement of fact. And the sooner the venture capital industry realizes this fact, and takes the lead on the capital gains issue, the sooner we can amend the tax reform law.

I am proposing that we reform the old capital gains tax to meet the legitimate objections which were raised to it during the tax reform debate. The venture capital gains bill takes the debate on capital gains back to its roots. It avoids ideology, it avoids supply-side magic, and it forces the opponents of the capital gains tax preference to debate real issues.

In any event, the revenue impact of the President's campaign proposal is so severe, it is quite unlikely that it can be pursued next year or at any time in the foreseeable future. Next year we are facing a drastic and mandatory reduction in the deficit under the Gramm-Rudman-Hollings law. We may have to cut $40 or more from the fiscal 1990 deficit. It is inconceivable that the Congress can seriously consider a proposal which is estimated to increase the deficit by tens of billions of dollars.

It will also be difficult to consider the venture capital gains bill this year, but, it will not be impossible to consider it. It does lose revenue, but this year the Congress may well enact a significant tax increase. If that tax increase involves tinkering with tax rates, particularly the 33 percent recapture bracket, it is quite possible that Congress will balance this move by reducing the maximum capital gains tax rate to 28 percent or even reduce it along the lines suggested in my bill. So, there is a plausible scenario for considering my bill this year and there is no plausible scenario for considering the President's campaign proposal.

For these reasons I must oppose the President's campaign proposal on capital gains. That proposal is counterproductive to the goal of encouraging long-term, high-risk investments. It delays the day when we can focus on a reasonable, responsible and realistic capital gains proposal. It is not a realistic option in the current budget climate.

If our only choice is between the President's campaign proposal and nothing, I would have to prefer no change in the current law. And it is in the interest of the venture capital industry to take the same position.

But, that is not the choice. We can restore a capital gains preference which is fiscally responsible, which will generate economic growth and jobs, which complements the tax reform legislation, and which is tailor made for the venture capital industry.

I am convinced that the venture capital gains bill is a solid, practical and reasonable proposal. It is, in fact, the only realistic option which has been proposed to restore the capital gains tax preference.

I ask unanimous consent that a table summarizing the differences between my capital gains proposal and that of the President during the campaign be printed at this point in the RECORD.

There being no objection, the table was ordered to be printed in the RECORD, as follows:

COMPARISON OF CAPITAL GAINS PROPOSALS

	Bush campaign	Senator Bumpers
Maximum tax rate	15 percent	21 percent.
Exclusion on gain	Unknown	25 percent.
Holding period	1 yr	4 yrs.—Favors long-term investments.
Investments covered	Any capital asset, including stock, real property and collectibles.	Stock of small business ($100,000,000 paid in capital).
Capital formation	Covers secondary market trading.	Covers only direct investments in new stock issues.
Windfall	Retroactive to past investments, confers huge windfall.	Only applies to new investments: no windfall.
Minimum tax apply	No	Yes, ensuring fairness.
Revenue loss	$40,000,000,000 over 3 yrs.	Less than $[illegible] over 3 yrs.

PREPARED STATEMENT OF SENATOR JOHN H. CHAFEE

Thank you, Mr. Chairman, I would like to express my appreciation to you for holding this hearing to examine the President's budget so early in the year. It is vitally important that we give serious consideration to the President's budget and I hope the Congress will work with the administration in a bipartisan effort to make dramatic progress on the deficit for fiscal 1990.

We must get the budget deficit under control to show the taxpayers that the Congress and the administration can exercise fiscal restraint. It is wrong in a time of prosperity to be spending more than we take in. The cloud on the horizon continues to be the budget deficit. The prospect of higher interest rates, sluggish investment, fewer jobs, and a decline in our national standard of living will always exist if the deficit remains high.

I am very happy to see the President include in his budget proposal two issues that are very important to the competitiveness of American industry in the world market and to our international trade deficit. The issues I am referring to are the research and development tax credit and the rule on the allocation of research expenses of multinational firms.

The R&D tax credit has been incredibly successful; since the enactment of the credit, private research and experimental expenditures in the United States have reached record levels. I believe we must make this credit permanent and restructure it according to the Baucus-Danforth bill to continue its incentive effect and make the U.S. industries more competitive in research and experimentation activities.

The rule on the allocation of research expenses is also very important in providing an incentive for our firms to perform their research in the U.S. and not transfer it overseas. Without these rules we will treat U.S. based research activities as if it was being performed overseas and thus give them an incentive to move these activities off-shore.

I would like to briefly address several expiring tax provisions that are not contained in the President's budget. I believe we need to fully examine the benefits and drawbacks of these programs and provide some guidance as to the likelihood that these programs will or will not be extended.

The mortgage revenue bond program is an important part of the state housing program in my home state. Home ownership is an important part of the American dream and I believe we need to continue to provide tax incentives for programs that assist lower income Americans in acquiring their first home. We need to reverse the declining home ownership trend that has existed since 1980.

Recent testimony before the Senate Housing Subcommittee suggests that the dream of homeownership is becoming more and more difficult to achieve for many Americans. Today, the nation's homeownership rate is at its lowest level in 15 years. This decline occurs at a time when members of the baby boom are at the prime homebuying age and during one of the most sustained and vigorous housing recoveries on record.

In 1986, we adopted a state volume cap which placed a limit on the total amount of private purpose tax-exempt bonds that could be issued by a state. The MRB program expands the types of private-purpose bonds that can be issued by a state within its volume cap. I believe it is vitally important that we allow states to utilize the volume cap in the most beneficial way for each state's programs and activities.

I have received a great deal of information from the Rhode Island Housing and Mortgage Finance Corporation, which manages the MRB program in my state, that illustrates the vital importance of this program to fulfilling the homeownership dreams of low-income Americans. In the 15 years that Rhode Island Housing and Mortgage Finance Corporation has existed, almost 35,000 families have been able to purchase a home utilizing a mortgage from our MRB program.

I believe it is imperative for us to extend the authority of the states to issue tax-exempt bonds to provide Mortgage Revenue Bond financing to our young families who would not otherwise be able to fulfill the American dream by purchasing a home.

I would also like to express my support for an extension of the low-income housing tax credit that expires at the end of this year. We created this tax credit to encourage construction and rehabilitation of housing for low-income Americans. The credit has the potential for expanding the supply of affordable housing and, in fact, is necessary to provide adequate housing for the poor.

Providing the necessary housing supply for the poor is a long-term job, the state housing agencies must invest a considerable amount of time and resources in the development of the necessary capacity to administer them. In addition, private housing developers must have considerable lead time for the projects. These necessary participants in the program need to know that it will be extended past 1989, in order to encourage them to make the required investments in time and resources.

The exclusion for employer-provided group legal services is another important program that helps a wide variety of individuals to obtain necessary legal services. In a time of rising legal fees, when the cost of adequate legal representation is out of reach of many individuals, I believe we need to extend this program. However, this program must be available to individuals at all income levels and job levels within a company, and should not discriminate in favor of higher income employees.

I look forward to hearing the testimony of our distinguished witness on these important issues. Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, over the past several years, this Committee has held hearings on a number of subjects that directly bear on the competitiveness of the United States in the global economy. Three years ago, we rewrote our tax laws with an eye towards leveling the competitive playing field for our nation's industries. Two years ago, we rewrote our trade laws with the goal of opening and expanding the global marketplace. And less than two months ago, we held extensive hearings to examine the impact that leveraged buyouts and corporate debt are having on our ability to maintain long-term competitiveness in that global marketplace.

I believe that President Bush's capital gains proposal also should be viewed in light of how it will affect America's competitiveness in the global market. In that vein, I would preliminarily note that nearly all of our major trading partners, including West Germany, Japan, Canada, Taiwan, South Korea and most of the EC countries, either exempt long-term gains from taxation, or impose a tax far lower than the U.S. tax. Although it would not be fair to attribute our short-term trade problems to how we tax long-term gains, I believe the issue is very important to the overall long-term health of our economy.

Mr. Chairman, last year I introduced legislation that would have provided a sliding-scale long-term capital gains differential with a minimum four-year holding period. I introduced that bill because I believed, and still believe, that a real long-term capital gains differential will help to encourage a shift in investment strategy away from the short-term and towards the long-term. I think President Bush's proposal to allow a capital gains differential for assets held three years will also go a long way to achieve that goal. And I would note that my distinguished colleague from Minnesota, Senator Rudy Boschwitz has offered several capital gains proposals that have sought to encourage more entrepreneurship and long-term investment.

I think it is important to point out that the current tax code makes almost no distinction between the entrepreneur who risks his capital on an unproven new-frontier technology and the arbitrage speculator who gets in the middle of the latest corporate takeover. In fact, our current system penalizes the long-term investor and entrepreneur because it does not factor in the impact of inflation on assets held for a substantial period of time. By allowing an exclusion for truly long-term gains, President Bush's proposal diminishes the impact of inflation on asset values, and reduces the possibility that investors are taxed on phantom gains.

Furthermore, I believe that establishing a differential for long-term gains will help to alleviate the current bias in the tax code which favors debt instead of equity. Although our recent hearings on LBOs failed to produce a consensus on the long-term impact that such transactions have on our economy, I think it is fair to say that if there was a consensus from all of the witnesses, it was that we must do something to eliminate the current tax code bias in favor of debt. Although a capital gains differential will not completely eliminate this bias, it will reduce the cost of capital for American companies, while increasing the after-tax rate of return for stock.

Mr. Chairman, much of the focus of our debate will surely focus on the revenue effects of cutting the capital gains tax. While Treasury estimates a six year revenue gain of 9.3 billion dollars, the Joint Tax Committee estimates a 24.2 billion revenue loss. While I look forward to hearing from Dennis Ross and Ronald Pearlman defend their estimating techniques, I would note that neither estimate assumes how much additional revenue will be generated as a result of increased growth in the overall economy that I anticipate will occur if we cut the capital gains rate.

Mr. Chairman, we should not approach the issue of capital gains by narrowly focusing solely on how many more capital gains realizations will occur if we lower the tax rate. Instead, we should be considering whether or not a long-term capital gains differential will stimulate new investment, growth in the economy, long-term corporate investment and increased global competitiveness. I believe the answer to these questions is yes, and I hope that these hearings will convince the members of this Committee of the importance of adopting the President's proposal.

CTJ

Citizens for Tax Justice

Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the Senate Finance Committee
Concerning President Bush's Proposed Tax Cut For Taxpayers with Capital Gains
March 14, 1989

I appreciate the opportunity to appear before the committee today on behalf of Citizens for Tax Justice. Our coalition of labor, public interest and grassroots citizens groups represents tens of millions of middle- and low-income Americans, who have a vital stake in fair, economically sound tax and budget policies.

The Tax Reform Act of 1986, which we strongly supported, took long overdue steps to repudiate a tax code that along with fostering widespread corporate tax avoidance, allowed half of the wealthiest people in the country to pay a lower share of their incomes in federal taxes than was paid by families at the poverty line. Tax reform wasn't easy. To get the bill through the Senate, the Finance Committee had to figure out how to slash the top income tax rate to less than 30 percent without giving a windfall to the rich. The final reform bill cut the Gordian Knot with two bold swipes: strict limits on using tax-shelter "losses"—the effective tax rate on investments now can't be less than zero—and an end to the special break for capital gains.

Together these two changes form the core of the individual tax reforms in the 1986 tax act. They explain why the final bill was able to reduce the top income tax rate on the highest earners to only 28 percent without being a total boondoggle for the wealthy. Continuing the old loophole (or indexing gains for inflation, as some suggested) would have required a top rate of well over 40 percent to have been fiscally and distributionally neutral.

The reason why the treatment of capital gains is so central to tax fairness is that capital gains are the single largest source of income for the rich. Altogether, profits from selling stocks, bonds, real estate and so forth account for more than a third of the income of people making more than $200,000. The old rule exempting from tax 60 percent of such capital gains saved these top-income folks an average of $41,683 in taxes every year. In contrast, the break was worth less than $20 a year to families earning under $50,000.

Fairness was not the only reason why ending the capital gains exclusion was so important. The old capital gains break provided a key impetus for many economically wasteful tax shelters that diverted resources away from more useful activities. For instance, it fueled a huge

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wave of excessive office building construction that produced vacancy rates averaging close to 20 percent in most big cities. It diverted resources into unproductive investments such as antiques, llamas and embryonic cattle breeding. A 1981 study by the Agriculture Department found that capital gains treatment for breeding sows actually led farmers to change their breeding practices to a much less efficient approach in order to maximize their tax savings. And as much as one-third of the old tax code was devoted to complicated, largely unsuccessful attempts by lawmakers to restrict abuses of the capital gains break.

As a result of the 1986 Tax Reform Act, profits from selling stocks, bonds, land and so forth now are taxed at the same rates as wages, interest or other kinds of income. But now President Bush wants to reverse course. He proposes to exempt 45 percent of capital gains from tax, with a maximum rate of 15 percent. His plan represents the first major effort on the part of the opponents of tax reform to undermine the 1986 act.

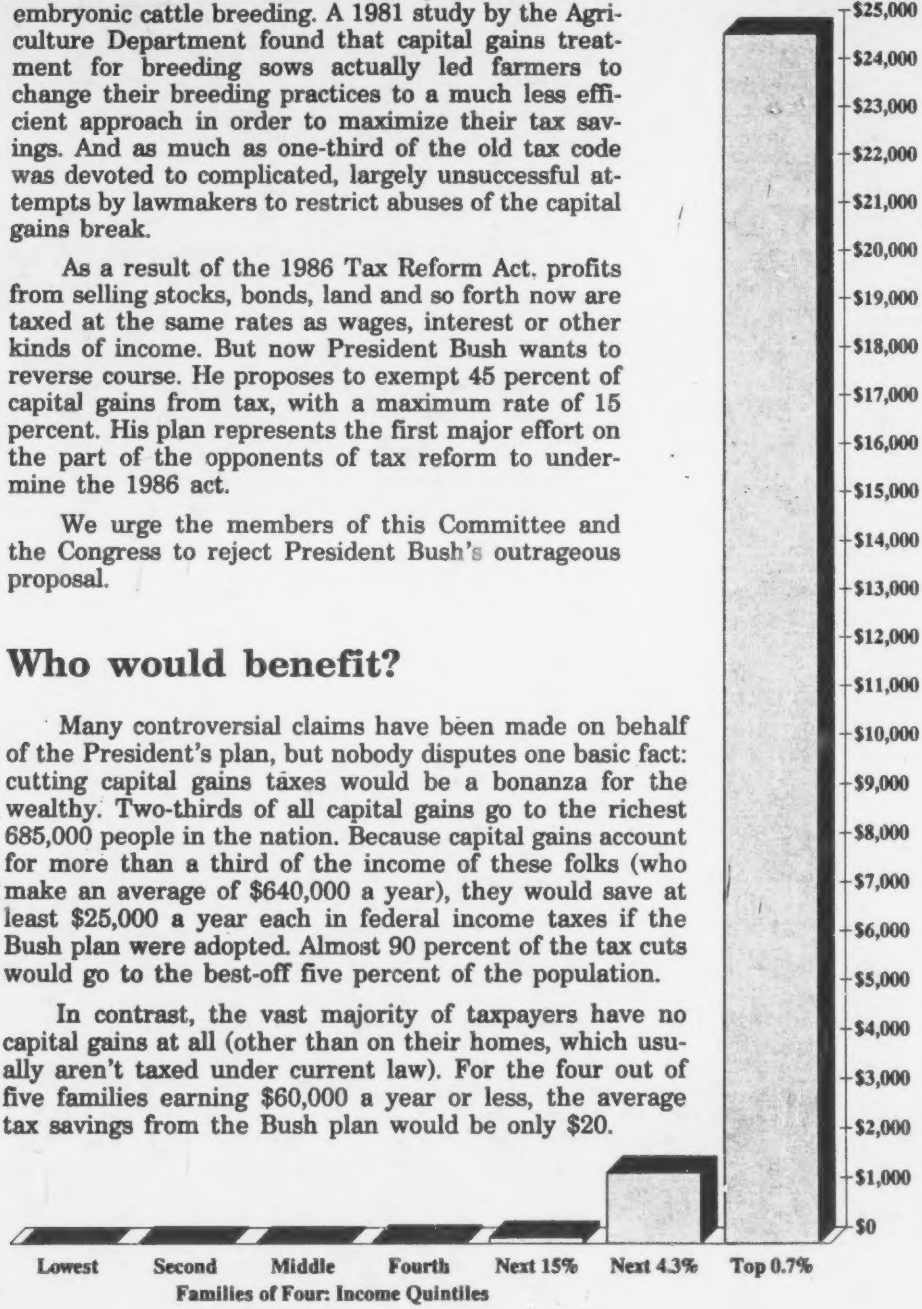
We urge the members of this Committee and the Congress to reject President Bush's outrageous proposal.

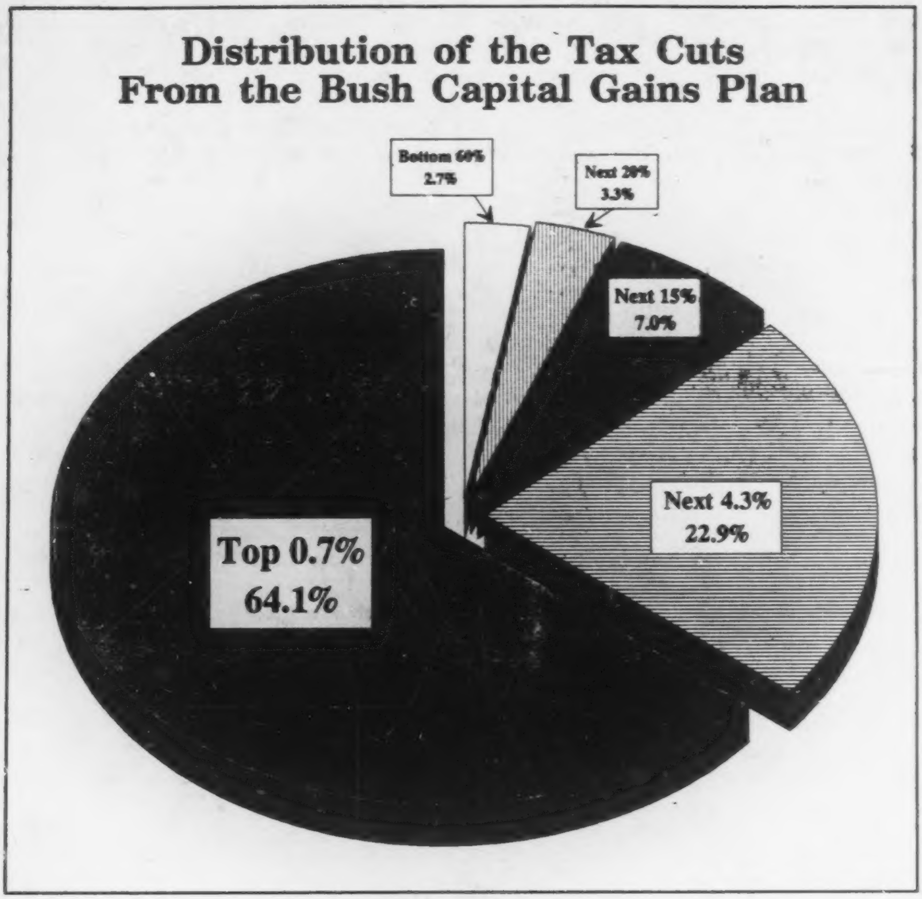
Who would benefit?

Many controversial claims have been made on behalf of the President's plan, but nobody disputes one basic fact: cutting capital gains taxes would be a bonanza for the wealthy. Two-thirds of all capital gains go to the richest 685,000 people in the nation. Because capital gains account for more than a third of the income of these folks (who make an average of $640,000 a year), they would save at least $25,000 a year each in federal income taxes if the Bush plan were adopted. Almost 90 percent of the tax cuts would go to the best-off five percent of the population.

In contrast, the vast majority of taxpayers have no capital gains at all (other than on their homes, which usually aren't taxed under current law). For the four out of five families earning $60,000 a year or less, the average tax savings from the Bush plan would be only $20.

Average Tax Cuts Under Bush Plan





Distribution of the Tax Cuts From the Bush Capital Gains Plan

The administration's claims

On its face, the Bush proposal looks hugely expensive. If there were no change in behavior by wealthy people, the administration itself estimates that its tax-cut plan would add upwards of $17 billion a year to the federal deficit.

But, without doubt, there would be changes in how rich people arrange their affairs. Most obviously, restoring the capital gains loophole would reinvigorate the tax shelter industry. Tax scams designed to convert ordinary taxable income into capital gains would proliferate, adding billions and billions of dollars more to the revenue cost.

The Bush administration doesn't disagree that tax shelters would be a serious problem—although it lowballs the revenue impact at only $2-3 billion a year. But, don't worry, says the President. Reducing capital gains taxes, he argues, will encourage savings. It will stimulate venture capital, he maintains.

And most important, President Bush insists, lowering capital gains taxes for the wealthy will set off such a sustained surge of selling of stocks (and other eligible assets) that it will actually raise revenue for the Treasury.[1]

It's a familiar litany, and it's been discredited time and time again. The virtually inexplicable claim about savings runs afoul of the fact that the personal savings rate plummeted to historic lows following the last round of capital gains tax cuts in 1978 and 1981. The idea that those previous tax cuts produced a flood of venture capital into risky, but socially useful enterprises was refuted by a 1985 Congressional Budget Office report, which found (a) that the growth in the venture capital industry was well underway before the 1978 capital gains tax cut took effect (following a rapid surge in demand for high-technology electronic products in the mid-seventies) and (b) that almost all the increase in venture capital investment after 1978 came from tax-exempt pension funds and other entities that were unaffected by the tax changes. In contrast, the share of venture capital supplied by individual investors (for whom the capital gains tax cuts were supposed to be an "incentive") declined markedly.

What allowed pension funds to get into venture capital was a 1978 relaxation of a federal rule limiting "risky" pension investments. What attracted the funds was the extremely high rates of return that venture capital offered. In truth, tax reform is likely to be good for the venture capital industry—since some of the dollars that previously went into tax shelters will be lured by venture capital's high profitability.

A recent article in the Sunday, February 26, 1989 *Washington Post* business section summarizes the evidence about venture capital investment in the wake of the 1986 Tax Reform Act, and illustrates that Congress was right not to be concerned that the '86 reforms would endanger such activity.

> Few hard statistics have rolled in about the impact of the 1986 capital gains changes, which made gains subject to the same tax rates as wages and salaries. But interviews with some leading denizens of California's Silicon Valley suggest that high-tech ventures have been proliferating lately. Some companies have been forced to offer higher pay for managerial talent, but to critics of Bush's proposal, such a modest impact is about what should be expected.
>
> "Look, suppose someone is really going to hit it big and make, say, $10 million," said Charles McLure, a tax expert at the Hoover Institution who as a Treasury assistant secretary played a key role in formulating the tax-revision proposals that led to the 1986 law. "Does it really matter to them a whole lot whether they're going to keep 72 percent of it [as under current law] or 85 percent of it [as would be true under Bush's plan]? It doesn't seem like it should make any difference." . . .
>
> [Even] the proponents [of the Bush plan] concede . . . that despite the 1986

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[1] The administration also suggests that its plan might be seen as a rough-and-ready substitute for indexing capital gains for inflation. To be sure, a theoretical case can be made for indexing, so that only "real" gains are taxed. But to work fairly, such a plan must entail disallowing deductions for the inflationary component of interest payments, as well as taking account of the fact that, unlike other kinds of income, capital gains aren't taxed until assets are sold. Indexing was rejected in 1986 in favor of a lower top tax rate—as noted earlier, if gains were indexed, a rate in excess of 40 percent would be necessary to be fiscally and distributionally neutral. And whatever the merits of inflation indexing, it's not at all what the administration has proposed.

> law, plenty of capital has been available in the past couple of years to help develop and expand young enterprises.
>
> "It's true there hasn't been an abatement of funds into the venture industry," said Norman Fogelsong, general partner at the Mayfield Fund in Menlo Park, Calif. That isn't surprising, Fogelsong, said, because, "most investors in venture capital"—pension funds, university endowments and the like—"have tax-exempt status anyway." . . .
>
> And even among venture capitalists, there are some who see virtually no effect on entrepreneurial activity from the 1986 tax changes.
>
> "I personally don't think many people make a decision to start a company based purely on the economics," said Bill Hambrecht, president of Hambrecht & Quist, a San Francisco venture capital firm. "People who want to start their own companies generally do it because they believe in an idea, and want to prove themselves."
>
> Similar motivations lie behind decisions by managers to leave big companies for smaller ones, Hambrecht said. Those people "want to be part of something that's just getting off the ground," he said. "I find people are still very attracted by the idea of some ownership in a company, and whether that ownership gets taxed at 25 percent of 33 percent—I haven't met anybody yet where I thought that was the crucial factor."

How much would the Bush plan cost?

One might be tempted to dismiss out of hand the President's final assertion: that cutting capital gain taxes would increase tax collections. After all, the Reagan administration and the Congress only recently concluded that *eliminating* the capital gains loophole would significantly augment revenues. (Perhaps jokingly, Bush officials call the diametrically conflicting estimates "generally consistent.") But because that implausible premise is at the heart of the administration's case for undermining tax reform, it needs to be examined carefully.

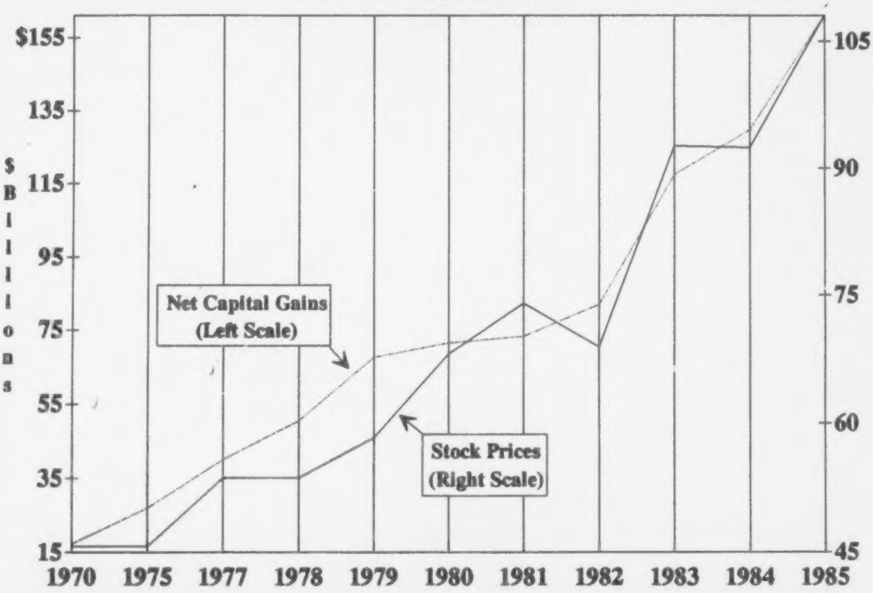
The administration unabashedly predicts that if its plan is adopted, wealthy people will more than double their annual reported capital gains (a necessity to offset the virtual halving of their tax rate). For example, in 1993, according to the administration, capital gains (not counting those ineligible for the proposed tax break) will jump from about $148 billion to $309 billion—an increase of 108 percent!

Administration Predictions About Capital Gains Realizations (Eligible Gains Only) ($-billions)

Fiscal Years—	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Current Law:	$129	$140	$148	$154	$158	$162	$165	$169
If Bush Plan Is Adopted:	$284	$298	$309	$261	$301	$243	$332	$350
% Increase:	*+120%*	*+112%*	*+108%*	*+69%*	*+91%*	*+50%*	*+101%*	*+107%*

Is there any reason to expect that to happen? The Joint Committee on Taxation doesn't think so. It estimates that adopting the administration plan would cost $25 billion over the next several years—an estimate that has to be viewed as extremely conservative. But President Bush continues to press his argument. After the top capital gains tax rate was reduced from about 38 percent to 28 percent in 1978 and to 20 percent in 1981, he points out, reported capital gains increased rapidly. Post hoc, ergo propter hoc, he concludes. But look:

From 1977 to 1985, the total value of stocks listed on the New York Stock Exchange grew by more than $800 billion. It's no surprise, therefore, that reported capital gains on corporate stock were about $40 billion higher in 1985 than in 1977. (One can't credit the capital gains tax cuts with the rise in the stock market, by the way. For one thing, an incentive to sell doesn't usually boost prices. For another, stock values almost doubled from 1982 to 1986, a period that saw *no* change in capital gains taxation, and they've gone up by 15 percent more since the end of 1986, after the top capital gains tax rate was *increased* from 20 percent to 28 percent.)



Capital Gains & Stock Prices

1979 to 1985

NOTES: Stock Prices are the New York Stock Exchange Composite Index, which includes all stocks listed on the N.Y. Stock Exchange (Dec. 31, 1965 = 50). Net Capital Gains are capital gains less capital losses included in AGI, before the 50% or 60% exclusion.
SOURCES: The Economic Report of the President, *Jan. 1989, p. 416. IRS,* SOI Bulletins.

Another big factor boosting reported capital gains was the boom in tax shelters that occurred in the first half of the 1980s. In 1985 alone, some $85 billion in tax shelter "losses" were reported on individual tax returns (up from less than $10 billion in 1978). There's no doubt that the 1978 and 1981 capital gains tax cuts helped spur that shelter activity, since a primary purpose of the shelters was to allow the rich to transform their regularly-taxed income into lightly-taxed capital gains. But this source of increased capital gains obviously didn't increase government tax collections. Quite the contrary. As Michael Kinsley of *The New Republic* has aptly noted, if the government gave a 50 percent tax cut to people whose name is "Bush," it's quite likely that taxpayers named "Bush" would pay more taxes, since lots of people would change their name. But that hardly would mean the tax break had led to higher total revenues.

Recently, a major source of reported capital gains has been the wave of corporate mergers, hostile takeovers and leveraged buyouts, which have generated close to $600 billion in essentially forced stock sales over the past five years. The involuntary capital gains produced by these deals plainly aren't affected by the tax rate on capital gains.

The historical evidence seems clear. If capital gains taxes had not been reduced in 1978 and 1981, the government would have collected much more in revenues—and the federal budget deficits would have been much lower—than was actually the case. In fact, that's exactly what happened in Canada, where reported capital gains grew in almost exactly the same pattern as in the U.S., despite no change in Canada's tax treatment of capital gains.

Conclusion

The 1986 tax reform act represented a drastic change in philosophy by Congress and the Reagan Administration. After years of experience, it finally was determined that tax breaks for the wealthy are an expensive, inefficient and counterproductive way to try to improve economic conditions. As an October 1987 Congressional Budget Office report illustrates, however, the tax act was far from a complete victory for tax fairness. Even after reform, the richest one million people in our country are paying a 25 percent lower share of their incomes in total federal taxes than they were ten years ago, while taxes on the poorest 20 million American families are up by 17 percent. Meanwhile, the tax system continues to fail at what ought to be its fundamental task—raising enough money to pay for the cost of government programs.

We can't undo the errors of the past, but we certainly don't have to repeat them. It's heartening that the key congressional leaders in the 1986 fight for tax reform have made it clear they firmly oppose President Bush's call for another supply-side round of tax giveaways to the rich. But we need to persuade the President that extending tax reform, rather than sabotaging it, is imperative if we are to cut the budget deficit and curb the immoral borrowing from our children's future that has been the unfortunate hallmark of the 1980s.

PREPARED STATEMENT OF RONALD A. PEARLMAN

Mr. Chairman and Members of the Committee: I am pleased to have the opportunity to appear before you today to discuss some of the issues involved in this Committee's consideration of the Administration's proposal to reinstitute a preferential capital gains rate.

I have two objectives this morning. First, to highlight some of the important policy issues relevant to the capital gains debate and second, to explain our estimate of the revenue impact of the Administration's capital gains proposal.

I. INTRODUCTION

Yesterday, we released a hearing pamphlet [1] intended to provide members of the Committee with background information that hopefully will be helpful in your consideration of various capital gains proposals. At pages 18–22, the pamphlet details a number of arguments in support of and in opposition to a preferential capital gains rate. This discussion, and my comments this morning, are not intended as a recommendation of a course of action; they are neither statements favoring nor opposing the Administration's proposal. Instead they are intended to highlight the very important policy considerations which have been largely ignored as we debate the revenue impact of capital gains rate change.

II. POLICY CONSIDERATIONS

Because these issues are set out in some detail in the hearing pamphlet, I wish only to refer very briefly to those which I consider most significant.

Savings and Capital Formation—An important part of the historical debate on the tax treatment of capital gains has been the influence of a preferential capital gains tax rate on national savings and capital formation. While a reduction in the tax on capital gains may possibly create substantial unlocking effects, there is no clear evidence in the economic literature regarding the effect of this unlocking on national savings and capital formation.[2]

Holding period—Some suggest that it would be advantageous for the nation's business climate if investors held their assets longer. Our analysis suggests that a preferential rate for capital gains could lead to a shortening of holding periods, even under the Administration's 3-year holding proposal.

Inflation—Much has been said about the over taxation of inflationary capital gains. While a tax preference for capital gains would provide a crude offset to the effects of inflation, history shows us that the preference also creates opportunity for tax sheltering. A precise measurement of economic income would adjust for inflation.

Complexity—The Congress is continuously assaulted because of the increasing complexity of the tax laws. The elimination of the preferential rate for capital gains was one of the most significant, and perhaps the most significant, simplification of the business and investment tax system resulting from the Tax Reform Act of 1986. That is not to mean the 1986 Act achieved maximum simplification—distinction between capital and ordinary income remains in the Code for the purpose of limiting capital losses and in anticipation of a return of a preferential rate. Although complexity remains, it is much less than before the 1986 legislation. If Congress chooses not to enact a preferential tax rate for capital gains, substantial simplification possibilities remain in refining the distinction between capital and ordinary income.

III. IMPACT OF CAPITAL GAINS ON FEDERAL REVENUES

A. In General

As you are aware, one of the responsibilities of the Joint Committee is to provide estimates of the revenue impact of tax legislation under consideration by the Congress. A revenue estimate represents our best judgment of the increase or decrease in Federal receipts that would result from a change in the law. Our reference point for this purpose is the five-year budget baseline for Federal receipts provided to us by the Congressional Budget Office (CBO). Our revenue estimating conventions require that this baseline remain fixed throughout the relevant budget period; it is unaffected by any proposed tax law change. This baseline includes an estimate of the annual net dollar value of sales of capital assets, which we refer to as "capital gain realizations."

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[1] Joint Committee on Taxation, *Tax Treatment of Capital Gains and Losses*, JCS–7–89, March 11, 1989.

[2] Neither the Joint Committee staff nor Treasury has attempted to predict whether the Administration's proposal would have any so-called supply-side response such as accelerated investment, GNP growth, or increased stock market activity.

For most revenue estimates, we rely on large computerized microsimulation models of the U.S. tax system. Each computer model essentially is a sophisticated tax calculator. When we are asked to estimate the revenue impact of a proposed change in the tax law, the model permits us to calculate the income tax paid under present law and compare that tax with the hypothetical tax which would be paid if the law were changed. Additionally, we also can examine how the proposed law affects the after-tax distribution of taxpayer incomes.

Our individual and corporate computer models use as their primary input the confidential tax returns of individuals, corporations, and fiduciaries, drawn from a sample of actual tax returns filed by taxpayers. However, few of the requests for revenue estimates that we receive can be analyzed solely by looking at tax return data. Instead, they require additional data not readily available from the income tax return. Therefore, in providing the Congress with our revenue estimates, we rely on a number of other data sources. These include, but are not limited to, corporate financial statements, census surveys, data compiled by the Federal Reserve Board, the Social Security Administration, and the Commerce Department's Bureau of Economic Analysis, and the macroeconomic forecasts of various private firms.

In addition to analyzing the large amount of data at our disposal our estimators also take into consideration the anticipated taxpayer behavioral response to a proposed change in the law. Evaluation of taxpayer behavior is essentially a judgment call. The estimator's challenge is to make that call on the most educated basis possible. In doing so, we rely on empirical and theoretical research that has been conducted by economists and others, both from the private sector and from various government agencies. Most importantly, to the extent history gives us some guidance as to taxpayer behavior, we rely heavily on it. For example, in 1981 we used the best available information to estimate what we thought would be a modest taxpayer response to the expansion of IRA eligibility. In fact, taxpayer response was substantial. Many more taxpayers created IRAs than we had predicted. Consequently, our estimate was wrong. However, because the changes in the law regarding IRs made in 1981 and 1986 may help identify taxpayers' response to such changes, our future analyses of similar changes are likely to be more accurate.

Evaluating taxpayer behavior often involves balancing conflicting theoretical and empirical research. Arguably, there is no other area where this conflict is so evident as in the estimation of the revenue consequences of changes in the capital gains tax rate.

B. Revenue Estimates of Capital Gains

The decision to sell a capital asset, and to realize a gain or loss, is largely a discretionary decision on the part of an investor. Thus, in providing the Congress with revenue estimates relating to proposed changes in the individual tax rate on capital gains, we are faced with having to predict how taxpayers will respond to the new rate. We know very little about why investors choose to buy and sell assets; we do know that taxes are but one of many factors that enter into their decision-making process.

The economic literature on the effect of taxes on the decision to realize a capital gain, unfortunately, lacks consensus and, therefore, is not very helpful. This is both because of the wide range of estimates the economic literature has produced and the issues it fails to address. It has been our task to try to make some sense out of a diverse and complicated area while at the same time provide the Congress with a reasonable and prudent estimate of the effect of such a tax change.

C. Estimates of the Administration's Proposal

Table 1 contains our estimate of the Administration's capital gains proposal. Our estimate indicates that the Administration's proposal projects revenue increases in fiscal years 1989 and 1990 totaling $4.0 billion. Beginning in fiscal year 1991 we project revenue losses for that and each succeeding year. The total effect for fiscal years 1989 through 1994 is to reduce Federal revenues by $24.2 billion. The CBO baseline projections do not extend beyond 1994. We have extended our estimate beyond the conventional budget period by assuming approximately the same rate of economic growth as occurred in the 1990 to 1994 period. We estimate that for the period from fiscal year 1989 through 1999, the total effect of the Administration's proposal is to reduce Federal revenues by $67.0 billion.

As you can see from lines 1 and 2 of Table 1, our estimate of providing a 45 percent exclusion for the gain on certain assets sold on or after July 1 of this year assumes that taxpayers respond to this lower rate by selling existing assets to such an extent that federal tax revenues are increased, over and above the budget baseline for fiscal years 1989 and 1990. This increase in revenues results from taxpayer sales of capital assets in response to a change in the rate—this is the so-called short-run unlocking effect. It was observed following the 1978 and 1981 rate reductions; not surprisingly it also was observed in 1986 following passage of the 1986 Act but before the repeal of the capital gains preference took effect (see Table 2 and Figure 2).

We believe this initial "unlocking" of unrealized capital gains is a temporary phenomenon and that after an adjustment period, taxpayers will settle in to a lower, more permanent level of realizations. This is not to say that the level of capital gains realization will return to its level prior to a rate reduction. To the contrary, our revenue estimate assumes that individual taxpayers will realize more than $600 billion in capital gains during the budget period in excess of what would have been sold at the higher (current) tax rate.

The Administration's proposal reduces the tax rate on capital gains by close of 50 percent. As a result, if Federal revenues are to remain unchanged, realizations must double. If a permanent revenue gain is predicted, realizations must more than double. In our judgment, we do not think the historical record supports that result.

D. Differences Between the Joint Committee and Treasury Estimates

There are several differences between our estimate of the Administration's capital gain proposal and that provided by the Treasury Department's Office of Tax Analysis.

The vast majority of the difference in the estimates lies in the assumptions made about taxpayers' behavioral response to a reduction in capital gains tax rates. The Joint Committee estimate assumes a somewhat smaller long-run taxpayer response to the lower capital gains tax rate. While our estimated response is significant enough to offset approximately 70 percent of the so-called "static" revenue loss (Table 1, line 1), it is not large enough to show a long-run revenue increase. This is the most significant difference between the two estimates.

Beyond the difference in taxpayer response, there are several more minor differences between the estimates. First, the assumption as to the annual levels of capital gains realizations under the CBO budget baseline differs from that of the Administration. These differences, on the order of $20 to $30 billion annually, are due both to economic forecasts and differing assumptions as to the effect of the Tax Reform Act of 1986 on the subsequent realization of capital gains and losses. (CBO estimates a higher baseline level of realizations than does the Office of Management and Budget.)

Second, the Administration's proposal allows for a phase-in period after which only assets held for three or more years would be eligible for the reduced rate. The Joint Committee and Treasury estimates differ slightly on both the amount of asset sales which would be affected by this provision and on the extent to which taxpayers are able to postpone their realizations to take advantage of the lower rate. That is to say when, in 1993, only assets held for two or more years are eligible for the 45 percent exclusion, taxpayers with assets held for less than the prescribed amount of time have the option of postponing any sales until they qualify for the reduced rate. We anticipate that some taxpayers will speed-up their realizations to take advantage of the one-year holding period still available in 1992. Of those taxpayers who do not speed-up their realizations, some will wait until 1994 to qualify for the new two-year holding period. A similar argument holds when the holding period increases to three years in 1995.

Third, the offices differ somewhat on their estimate of the proportion of assets which would be eligible for the exclusion. This difference arises primarily from small differences in assumptions about the percentage of accrued gains held in the form of corporate stock, real estate, depreciable property, and collectibles.

Fourth, the Joint Committee assumes more taxpayers will be able to temporarily lower their adjusted gross incomes through the timing of business losses, for example, and thereby realize capital gains at tax rates below 15 percent.

It is important to emphasize that neither our revenue estimates nor Treasury estimates are made in a vacuum. Our staff regularly communicates with those of the Treasury Department, the Congressional Budget Office, and the Congressional Research Service, as well as with academic economists and others who are knowledgeable about capital gains and revenue estimating methodology. Ultimately, however, we make an independent judgment of how any tax change will affect the market place.

Many times the Joint Committee estimate and the Treasury estimate are nearly identical. Occasionally we disagree, as we do on the estimate of the Administration's capital gains proposal. However, our disagreement on the estimate is not total. Subject to our constraints to use different baseline assumptions, both the Joint Committee and Treasury estimate the Administration's proposal will result in a "static" revenue loss of $20 to $25 billion dollars per year (i.e., one that disregards the taxpayer response to the tax change) (Table 1, line 1). Moreover, both estimates contain substantial taxpayer behavioral response. The estimate we have made predicts that in the long run, changes in taxpayer response will be sufficient to offset approximately 70 percent of that static revenue loss. Treasury estimates that something over 100 percent of the static loss will be offset. While one might conclude that this difference merely is one of magnitude, I want to emphasize it represents a very significant difference in judgment about taxpayer response.

IV. DISCUSSION OF TAXPAYER BEHAVIORAL RESPONSE

A. General

As I stated above, the bulk of the difference between the Joint Committee estimate of the revenue effects of the Administration's capital gains proposal and the estimate made by the Treasury Department lies in different estimates of the magnitude of taxpayer behavioral response to the rate reduction. When taxpayers respond to a reduction in tax rates by realizing more gains, we refer to these additional gains as "induced realizations."

We arrived at our estimate after considering the many academic and government studies which have attempted to analyze how taxpayers respond to changes in capital gain tax rates and after undertaking our own analysis. In fact, members of our staff have contributed to the academic literature. Eric Cook, a former staff economist, and John O'Hare, a staff economist, published a paper which was the first to investigate the empirical importance of the effect of a preference for capital gains on the realization of dividend and interest income. This issue is referred to as the so-called "portfolio effect." [3]

An examination of the economic literature reveals that economic science does not speak with one voice on this issue. And, one of the first things any of these researchers will tell you is that his or her study is not perfect. To quote Professor Joel Slemrod of the University of Michigan, who has undertaken several studies of capital gain realization behavior,

> [T]he estimated tax responsiveness of capital gains realizations can be quite sensitive to the exact specification of the empirical model. In fact a specification search whose sole objective was to disprove the existence of a lock-in effect could be successful, as could a specification search designed to establish a large and significant lock-in effect. In this sense the data do *not* speak with one voice.[4]

Moreover, the empirical studies have created a substantial academic debate over methodological issues.

In these studies, economists characterize taxpayer behavior in terms of what they call an "elasticity." Mathematically, an elasticity for capital gains with respect to the tax rate is the percentage change in realized capital gains divided by the percentage change in the tax rate. This is merely a convenient mathematical way to measure taxpayer responsiveness. At its most basic level, the greater the responsiveness of taxpayers to a tax change, the greater the elasticity.

B. Methods of Empirical Analysis

The studies which have attempted to measure the elasticity of capital gain realizations with respect to capital gain tax rates have taken three primary forms: cross section studies; panel studies; and time series studies.

Cross section studies.—Briefly, a cross section study uses data on many taxpayers from one year. For example, the data may consist of a random selection of 10,000 tax returns all filed for 1985. Among the 10,000 taxpayers some will face high marginal tax rates and some will face low marginal tax rates. Some will realize many capital gains, and some will realize few capital gains. These studies try to infer the elasticity by relying on differences in tax rates and realizations across the sample of taxpayers.

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[3] *See* Eric W. Cook and John F. O'Hare, "Issues Relating to the Taxation of Capital Gains," *National Tax Journal*, vol. 60, September 1987.

Thomas Barthold, a staff economist, has also written papers on the subject. *See* Thomas A. Barthold, "In Search of a Test of Investor Capital Gain Realization Behavior to Capital Gain Tax Rates," *Economics Letters*, vol. 12, 1983, and "Investor Capital Gains Realization Behavior in Response to Capital Gains Tax Rates," Dartmouth College, December 1986.

[4] Joel Slemrod and William Shobe, "The Tax Elasticity of Capital Gains Realizations: Evidence from a Panel of Taxpayers," Xerox, University of Michigan, February 1989.

The major problem with cross section studies is that they rely on only one year for observation. Because taxpayers have the discretion to realize capital gains in a year when their marginal tax rate is low, and perhaps deliberately made so by successful tax sheltering, the studies cannot tell us what the long run effect would be to a change in tax rates. Cross section studies also cannot attempt to measure macroeconomic variables, for example GNP growth or inflation, which may be important.

Panel studies.—A panel study also uses data on a cross section of taxpayers but, in addition, follows these taxpayers across two or more years. So a panel study may look at the tax returns for the same 10,000 taxpayers for each of 1985, 1986, and 1987.

While many researchers might prefer to work with panel data because they combine both individual information with changes that occur over time, there have been relatively few panel studies and they have often had poor data with which to work. For example, the first panel study undertaken [5] utilized a sample of only approximately 1,000 taxpayers; when the analysis was restricted to high income taxpayers the sample of taxpayers was approximately 250. The data only tracked these taxpayers for period of five years. Even the Treasury Department's study,[6] while having the advantage of a panel of approximately 17,000 taxpayers only has data from five years in the early 1970s and uses a statistical form which limits the analysis of realizations to three years, years when there were no significant changes in the taxation of capital gains.

Time series studies.—A time series study uses aggregate data, rather than individual specific data, but uses data available for many years. A typical time series study will employ some measure of realizations for each year between 1954 and the present and construct an average marginal tax rate on gains for each year.

The major failing of time series studies is that they lack the individual specific data available in either cross section or panel studies. For example, the tax rate variable must be some sort of average marginal tax rate, or a hypothetical tax rate which need not apply to any specific taxpayer. Nor can a time series study control for the amount of interest or dividend income an individual taxpayer receives.

C. Predictive Ability of Empirical Studies

Without detailing the academic debate about the validity of these studies, from the point of view of producing a revenue estimate, the results of some of the studies must be discounted. For example, one academically important and often quoted study was undertaken by Feldstein, Slemrod, and Yitzhaki.[7] In one of its estimates the authors estimated a very high elasticity, so high that if one used it to predict capital gain realizations which would have resulted from the 1978 cut in capital gain tax rates, one would have predicted that, even accounting for other factors, realizations would have immediately and permanently tripled. In Table 2 we have reproduced a chart of capital gain realizations prepared by the Congressional Budget Office.[8] An examination of this table suggests that while there appears to have been a substantial taxpayer response to the 1978 tax cut, there clearly was not a tripling of gain realizations.

Similarly, Dr. Lawrence Lindsey of Harvard University employed a panel study [9] to estimate the revenue effects of the Tax Reform Act of 1986. Based on his analysis, with an implicitly high elasticity he predicted that 1987 capital gain realizations would be $83.6 billion. In fact, the Internal Revenue Services' Statistics of Income Division reports that actual 1987 realizations were $137 billion.

A possible explanation for this discrepancy might lie in the fact that Lindsey constructed his own series of baseline realizations to describe realizations in the absence of tax reform. His baseline may be lower than the comparable CBO baseline by 25 percent. However, even increasing his predicted 1978 realizations by 25 percent to $105 billion leaves his model far from the historical mark.[10]

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[5] Gerald E. Auten and Charles T. Clotfelter, "Permanent versus Transitory Tax Effects and the Realization of Capital Gains," *Quarterly Journal of Economics,* November 1982.

[6] U.S. Treasury Department, Office of Tax Analysis, *Report to Congress on the Capital Gains Tax Reductions of 1978,* September 1985.

[7] Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains, *Quarterly Journal of Economics,* vol. 94, June 1980.

[8] CBO, *How Capital Gains Tax Rates Affect Revenues: The Historical Evidence,* March 1988, pp. 25.

[9] Lindsey's panel is a panel of aggregate taxpayer adjusted gross income classes rather than a panel with individual specific data. *See* Lawrence B. Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," *National Tax Journal* vol. 60, September 1987.

I present these two examples not to criticize these two publications specifically or the quality of the academic literature in general. There is no question taxpayer response to a change in the capital gains tax rate is inherently difficult to address empirically. Rather, I refer to these two examples to suggest that the results of some of the studies predicting high elasticities lead to conclusions which are sufficiently inconsistent with history to lead our staff to discount them when arriving at a revenue estimate.

D. Summary

Typically, cross section studies have estimated higher elasticities than either panel or time series studies. The results of the time series and panel studies are somewhat similar in terms of order of magnitude while still containing sometimes substantial differences in their estimates of consumer behavior.

The paucity of yearly data in cross section studies and the existing panel studies may not permit these studies to adequately account for the effects that economic and stock market growth have on the pattern of gain realizations. In this regard Table 2 is again instructive. Table 2 shows that between 1954 and the early 1960s, gain realizations approximately doubled as nominal GNP grew by approximately 60 percent. This was a period when there were virtually no statutory changes affecting capital gains taxation. Between 1963 and 1973 the economy approximately doubled while gain realizations approximately doubled, and again during the majority of that period there was little change in taxes on capital gains. Table 2 and Figures 1 and 2 continue to show a relationship between gains and GNP to the present day.

This is not to suggest that all realizations are explained by GNP growth, but I think that we have to recognize that more than taxes can matter. Gain realizations also appear to move in reasonably close step with stock market performance as Figure 3 suggests. I make these observations because we believe it is important to account for these potential factors. Most time series studies, while lacking individual specific data, do account for factors such as GNP and stock market growth. As a result, while not ignoring the cross sectional and panel results, we rely most heavily on the results of time series analysis. We believe these studies are most consistent with the historical record.

In our estimate of the Administration's proposal we used a short-run elasticity of 1.20 and a long-run elasticity of 0.71 to measure the taxpayer behavioral response.[11]

We arrived at these elasticities based on our own analysis and our critical reading of the existing literature as discussed above. They correspond to no published study because no published study has limited its analysis to solely financial securities and non-depreciable real estate as the Administration's proposal attempts to do, and we have had to account for this targeting. Some may criticize these elasticities as too low and others as too high, but they represent our best judgment of the likely taxpayer behavioral response.

V. PLAUSIBILITY OF THE ESTIMATE

Because the Administration proposes a reduction in the tax rate on capital gains of approximately 50 percent, for the Joint Committee staff to have estimated that the Administration's proposal would be a *permanent* revenue raiser we would have to conclude that gain realizations would more than double, *and* this doubling would have to occur after one has already accounted for the growth of the economy on future gain realizations. For example, if the proposal had been effective from the beginning of this year, when the stock market is not markedly higher than in 1986, gain realizations would have to approximately equal the levels realized in 1986, a year which everyone believes was dominated by the timing effects induced by the announcement of a pending tax rate hike. We simply do not believe this conclusion is realistic and surely is not supported by historic realizations following past capital gains rate reductions when adjusted for economic growth.

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[10] This is a conservative analysis of Lindsey's estimate, because Lindsey claims to be estimating the permanent effect of the tax change. The 1986 and 1987 actual data reflect substantial short-term shifting of asset realizations in response to the announced tax change, leading to the actual 1986 realizations exceeding permanent realizations and 1987 realizations at a level likely to be below permanent realizations. Consequently, the actual 1987 figure is less than what one should expect as a permanent effect.

[11] In these elasticities we include the so-called "portfolio effect," the ability of taxpayers to convert ordinary income to capital gain income.

In the *seven-year* period between 1981 and 1987 taxpayers realized a *total* of approximately $1 trillion of capital gains. This seven-year period follows the 1978 and 1981 capital gains rate cuts and includes what is probably the strongest bull stock market in the nation's history. It also includes the tremendous temporary unlocking which occurred in 1986. For the Administration's proposal to generate permanent revenue increases in the five-year period from 1991 through 1995 (after the short-term effects of 1990), taxpayers would have to realize more than $2 trillion in gains.

While we project an initial surge in realizations (see Figure 2), we do not believe realizations will continue to surge on a permanent basis in relation to the nation's gross national product. Such a sustained increase in realizations in comparison to GNP appears to be outside the historical record (see Figure 2).[12]

The Treasury predicts a substantial increase in realizations. This can only come from two sources: one, taxpayers churning their portfolios faster; and two, unlocking of accrued gains which otherwise would have been held until death. If the only response to a rate cut is that taxpayers churn their portfolios faster, then the predicted realizations merely are being accelerated from a future date to the present. If this were the case, the long-run elasticity would be, in fact, approximately zero and ultimately the proposal must lose revenue.

We believe that it is implausible that the other source of increased realizations, gains which would otherwise be held until death, would be unlocked in substantial enough numbers to produce a permanent revenue gain. A 15 percent tax rate, while less than a 28 percent tax rate, is still significantly greater than the tax rate of zero a taxpayer can attain by holding an asset with an accrued gain until death. This leaves a strong incentive for many accrued gains to remain unrealized until death.

In addition, many overstate the penalty on a gain realized while living relative to that at death. While we do not tax capital gains at death, the estate tax is assessed on that part of gain which escapes tax when held until death. For taxpayers in the 50 percent estate tax bracket, this rule has the effect of reducing the capital gains tax on an accrued gain sold immediately prior to death from 28 to 14 percent (50 percent of 28). The Federal Reserve's Flow of Funds data indicate that for 1982 the market value of corporate equities was $1.24 trillion. Of this amout percent, or $1.03 trillion, was owned by individuals.[13] Of that amount $738 billion, or 71.6 percent, was owned by individuals with gross assets in excess of $500,000, and thereby potentially liable for the estate tax.[14] From this perspective, the gain from waiting until death is to reduce the effective tax rate from 14 percent under current law to 7.5 percent (50 percent of 15) under the Administration's proposal.

Admittedly dropping the tax rate from 28 percent to 15 percent may constitute the largest tax cut on capital gains in history, but the difference between the 15 percent rate from the top rate of 20 percent the nation had from 1981 through 1986 is small. We do not believe the historical record substantiates that a massive amount of unlocking of these gains will be forthcoming.

VI. CONCLUSION

It has been said that revenue estimating is as much an art as it is a science. Certainly all would agree that it is not an exact science. But economic theory and econometric methods are much more sophisticated than most of us realize. Revenue estimating assuredly is much more than an art.

The revenue effects of capital gains is a subject that has been debated extensively both within and outside government for many years. This year's discussion among economists and policy makers will not end that debate.

Every estimate is subject to uncertainty. However, in spite of this uncertainty, the Joint Committee has a job to do, namely, to provide the Congress the most informed and reasoned point estimate of the revenue impact of a proposed tax law change as we possibly can.

This certainly is not to say our estimate is necessarily correct. After all, it is an estimate. But I do believe the analysis we have employed in arriving at our estimate of the Administration's capital gains proposal reflects the best and most reliable of the economic theory and most accords with the history of prior capital gains rate adjustments. We believe a capital gains rate change will result in a significant short-run behavioral effect and more modest permanent behavioral effects. It is an analysis which is consistent with realizations following the rate reductions of 1978 and 1981. It is an analysis which is *inconsistent* with a prediction of permanently doubled realizations. And, it is our judgment that it is the most reliable analysis for use today.

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[12] We believe that in interpreting the surge of realizations in the early 1980s one must be careful to remember that not only was the economy in the middle of one of the largest bull markets in our history, but that the Congress also enacted substantially improved reporting requirements on the disposition of capital assets.

[13] *See*, Joint Committee on Taxation, *Federal Income Tax Aspects of Corporate Financial Structures*, JCS-1-89, January 18,1989, pp. 14.

[14] *See* Marvin Schwartz, "Estimates of Personal Wealth, 1982: A Second Look," *SOI Bulletin*, vol. 7, Spring 1988.

Accompanying me today are Randall Weiss, Deputy Chief of Staff of the Joint Committee, and Thomas Barthold, a member of the Joint Committee's staff of economists. We will be pleased to try to respond to your questions.

Enclosure

Table 1
REVENUE ESTIMATES OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Fiscal Years 1989-1999[1]

[Billions of Dollars]

	Item[2]	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
I)	45% Exclusion											
	"Static" Effect	-3.1	-20.8	-23.4	-25.4	-27.1	-27.8	-28.6	-30.1	-31.7	-33.3	-35.0
	Induced Realizations	3.3	21.4	17.2	16.6	17.4	16.2	16.6	17.5	18.4	19.4	20.4
	Total, 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	-12.0	-12.6	-13.2	-13.6	-14.7
II)	Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
III)	Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	3.3	3.4	3.6	3.8	4.0
IV)	Transition to 3-year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	2.2	-1.6	3.3	2.5	2.7
V)	Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	-0.6	-0.6	-0.7	-0.8	-0.9
Total, Revenue Effect		0.7	3.3	-4.0	-6.4	-6.9	-10.9	-7.1	-11.4	-7.0	-8.4	-8.9

Joint Committee on Taxation

NOTE: Totals may not add due to rounding.

[1] The official CBO baseline extends only through fiscal year 1994. Estimates for fiscal years 1995 through 1999 assume that the CBO baseline assumption for realizations continues to grow at the average rate of growth of the period 1990 through 1994.

[2] Item I has three subparts. The third is the net revenue effect which would result from a 45 percent exclusion, with a maximum 15 percent tax rate, for capital gains regardless of asset type assuming a one-year holding period and an effective date of sales on or after January 1, 1989. The first subpart shows the "static" revenue effect, that is the revenue effect assuming no taxpayer behavioral response. The second subpart, "induced realizations," shows the effect on revenues of new realizations undertaken and conversion of ordinary income to capital gain by taxpayers in response to the preferential rate.

Item II presents the estimated revenue effect resulting from moving the effective date of the proposal to July 1, 1989.

Item III presents the estimated revenue effect resulting from excluding collectibles and depreciable property.

Item IV presents the revenue effect of the lengthening, on a phased-in basis, of the holding period.

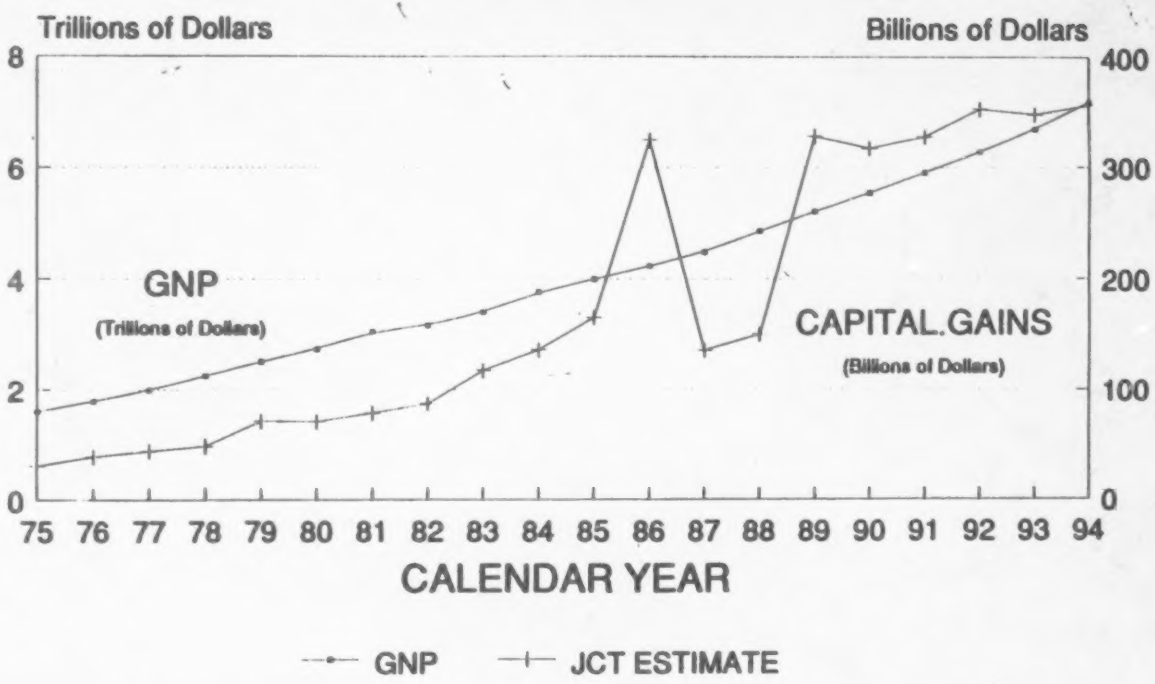
Item V presents the effect of providing a 100-percent exclusion to those eligible taxpayers with adjusted gross income less than $20,000.

Table 2
Congressional Budget Office
Calculation of Realization of Net Long-Term Gains and National GNP

Year	Realization of Net Long-Term Gains (billions of dollars)	Year-to-Year Percentage Change in Realizations	Gross National Product (billions of dollars)	Year-to-Year Percentage Change in GNP
1954	7.0	--	372.5	--
1955	9.7	38.6	405.9	9.0
1956	9.6	-1.0	428.1	5.5
1957	8.2	-14.6	451.0	5.3
1958	9.3	8.1	456.8	1.3
1959	12.9	38.7	495.8	8.5
1960	11.7	-9.3	515.3	3.9
1961	15.7	34.2	533.8	3.6
1962	13.6	-13.4	574.6	7.6
1963	14.5	6.6	606.9	5.6
1964	17.0	17.2	649.8	7.1
1965	20.8	22.4	705.1	8.5
1966	21.8	4.8	772.0	9.5
1967	27.3	25.2	816.4	5.8
1968	35.8	31.1	892.7	9.3
1969	32.6	-8.1	963.9	8.0
1970	21.3	-34.7	1,015.5	5.4
1971	28.2	32.4	1,102.7	8.6
1972	36.1	28.0	1,212.8	10.0
1973	35.8	-0.8	1,359.3	12.1
1974	30.0	-16.2	1,472.8	8.3
1975	30.7	2.3	1,598.4	8.5
1976	39.2	27.7	1,782.8	11.5
1977	44.4	13.3	1,990.5	11.7
1978	48.9	10.1	2,249.7	13.0
1979	71.3	45.8	2,508.2	11.5
1980	70.8	-0.7	2,732.0	8.9
1981	78.3	10.6	3,052.6	11.7
1982	87.1	11.2	3,166.0	3.7
1983	117.3	34.7	3,405.7	7.6
1984	135.9	15.9	3,765.0	10.5
1985	165.5	21.8	3,998.1	6.2

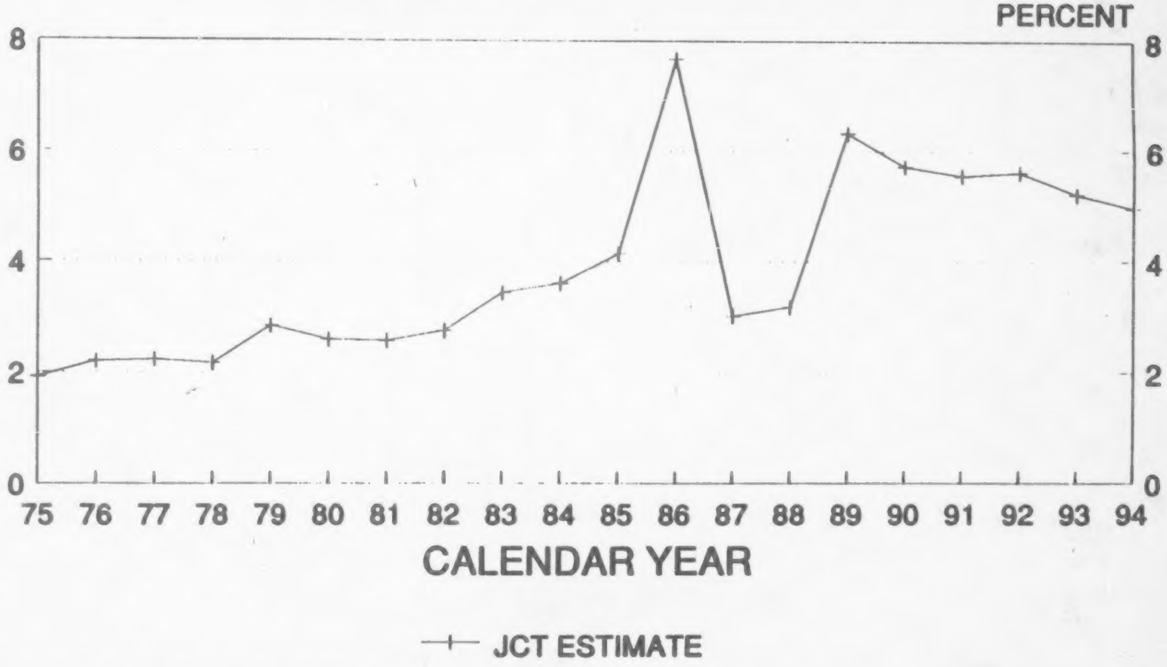
Source: CBO, How Capital Gains Tax Rates Affect Revenues: The Historical Evidences, March 1988.

Figure 1.
CAPITAL GAINS AND GNP
HISTORICAL AND FORECAST 1/



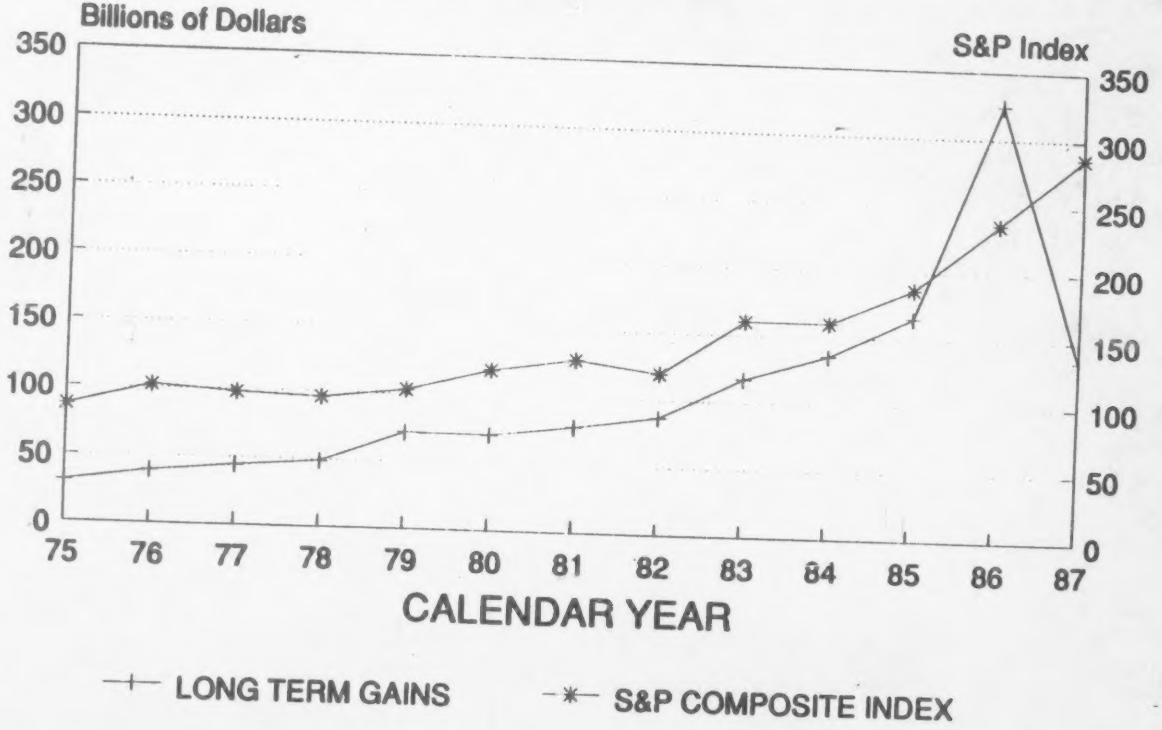
Source: Joint Committee on Taxation
1/ Prior to 1988, actual values are shown.

Figure 2.
CAPITAL GAINS AS A PERCENT OF
GROSS NATIONAL PRODUCT 1/



Source: Joint Committee on Taxation
1/ Prior to 1988, actual values are shown.

Figure 3.
CAPITAL GAINS AND THE STOCK MARKET
1975 to PRESENT



Source: Joint Committee on Taxation

PREPARED STATEMENT OF PAUL CRAIG ROBERTS

Mr. Chairman, members of the Finance Committee, I am Paul Craig Roberts. I have a research appointment at the Center for Strategic and International Studies here in Washington, where I occupy the William E. Simon Chair in Political Economy, and at the Hoover Institution at Stanford University, where I am a Senior Research Fellow. I am a former Assistant Secretary of the Treasury, a former editor and columnist for the Wall Street Journal, and a former professor at several universities. I have worked for the Congress both in the House and Senate and on members' and committee staffs. I have known some of you, such as yourself, Mr. Chairman, since those days.

I am a columnist for Business Week, the Scripps Howard News Service, the Financial Post of Canada, the Washington Times, and for European publications—opportunities that came my way because of the independence of my views. I do not speak for any interests. I am testifying at the request of this Committee. My careers are those of a scholar, a public servant, and a journalist. I have both worked for the Reagan Administration and been honored by the socialist president of France.

Having said this, it is not clear to me which, if any, organized interests are pushing for a lower capital gains tax. It has never been an important issue to the corporate community. Perhaps there is an association of individual investors or a group of talented people with comfortable jobs in large organizations who need an inducement to chuck their security and go chase their dream.

However, organized interests are actively opposing a lower capital gains tax rate, specifically organized labor and its spokesmen. As an economist, I find labor's opposition perplexing, even mindless. Tax actions that reduce the cost of capital bring about an increase in capital investment, which, in turn, improves labor productivity and raises labor's income.

The imbecilic argument that capitalists benefit from capital and labor benefits from wages is a proposition from which communist countries themselves are in full retreat. In the United States we are increasingly a capital intensive economy, but capital's share of income is not rising. This means that labor's income is rising in step with capital's, sharing the gains.

I am distressed when people cut off their noses to spite their faces. The claim that a reduction in the capital gains tax is unfair because it benefits the rich is a perfect example of self-mutilating behavior. It is also an example of a definition of fairness drawn so narrowly as to be self-defeating. From a rational standpoint, fairness has to be measured in terms of the relative success of our country in a competitive world economy. A tax policy designed to hold back "the rich" is not only unfair to the rich but also to labor and our competitive position. It is interesting, Mr. Chairman, that not a single country in the world agrees with the view that capital only benefits the rich. If we were to decide to punish the rich by giving away our capital, every country would be pleased to take it.

If capital benefits other people in addition to its owners, to whom is it unfair if we have more of it? How has the growth of capital in the U.S. over the past 300 years disadvantaged labor or the poor?

The only people disadvantaged by new capital are those with old, established wealth. New capital unleashes upstarts who bust up the status quo, create opportunities, and undermine the protected enclaves of the rentier class. New capital is the best thing an egalitarian society has going for it.

Moreover, as Appendix I shows, people with recurring annual incomes below $20,000 receive a larger percent of capital gains than those earning over $200,000.

To go to the crux of the matter, a capital gains tax is an unfair tax. It is not a tax on income, but on the rise in the price of an asset, reflecting either inflation or the stock market's estimate that a company's future earnings will be higher.

If the price of the asset rises because of inflation, there is no real gain at all, and the tax is nothing but a confiscation device.

If the price rises because the company's earnings improve, then these earnings will be subject to double taxation, first as company income and then as dividend income to individuals. Taxing the capital gain simply taxes the same income a third time.

When the unfair capital gains tax hurts ordinary people, we give them a special exclusion, such as the rollover and exclusion of the capital gains people have in their homes. However, when the capital gains tax hurts investment, envy crowds out logic and the economy suffers.

It is a puzzle to me that U.S. tax law treats capital gains as income, even though the national income accounts do not regard them as income and do not include them in the measurement of gross national product. What we have achieved is the triumph of envy over policy.

Ideologically, the American left sees the capital gains tax as a wealth tax. For those whose first allegiance is to equality, the more wealth taxes the better. For them, this is the real issue. Arguments about the revenue and economic effects of capital gains taxation are little more than a smokescreen to keep us from the crux of the real issue.

It is destructive of sound tax policy to confuse wealth taxes with income taxes. Moreover, it has allowed the political left to establish a wealth tax without having to be forthright and to make a case before the Congress and the American people.

The government of the world's leading capitalist nation should be able to do a more honest job of defining capital income. A good starting point is to reject the supposition that fairness in tax policy mandates discrimination against capital. Unlike income that is consumed, income that is saved and invested is subject to multiple taxation. This is a highly irrational tax policy for a country that is worried about its competitiveness, about long-range real funding for Social Security, about budget deficits, and about the smooth absorption of large numbers of immigrants from the Third World.

America needs all the capital that it can get, particularly in light of the flood of immigrants. This inflow is likely to rise as socialist failures around the world continue to come home to roost, causing people to give up on their own countries and to migrate here, legally or illegally, in pursuit of opportunity. We can no longer afford tax laws whose main purposes are to indulge envy and to provide ideological gratification for the anti-capitalist mentality, no matter what its economic cost.

I agree that one reason a lower capital gains tax rate produces more revenue is that it allows "the rich" to make more money. I agree that it gets the left-wing's hackles up for "the rich" to have more money. But I object to those who oppose a lower capital gains tax on the narrow grounds of what it would do for the rich.

If envy prevents you from cutting the capital gains tax rate, you can at least index it for inflation. That way only real gains in value would be taxed, and this would introduce a small element of fairness into an unfair tax.

The argument is made that we cannot cut the capital gains tax rate without opening up the 1986 tax reform bill. I fail to understand the logic of this argument, but so what? Let's open up the bill. That bill is no great accomplishment. Compared to the Treasury's proposal more than a decade ago of a cash-flow tax, the 1986 bill is not worth much. *Blueprints for Basic Tax Reform*, published in January 1977, presents a comprehensive reform that would make our tax system neutral in its treatment of saving. It is pointless to complain about low saving when the tax code is extremely biased against saving.

For reasons I will show, the 1986 bill largely missed the point. Indeed, if it had not been for this Committee at the last minute, the bill would have been a disaster and would have wrecked the U.S. economy. It was certainly a psychological victory to get the top tax rate down to 33%. That's about the maximum tax that could be extracted from a medieval serf. It is a victory that the American people no longer have to pay federal tax rates in excess of what the Robber Barons were able to extract from feudal serfs. Though, of course, when you add in Social Security, state and local taxes, Americans are far more heavily taxed than medieval serfs. You need to ask yourselves in what sense a person is free who is not a majority shareholder in his own income.

It has become fashionable in some circles to present the 1986 tax bill as some sort of final deal cut between the forces of opportunity and the forces of envy. According to various people, including some of those with power over tax legislation, we cannot improve the prospect for capital investment in one part of the tax code without worsening it in another.

For example, the argument has been made that if we want to cut the capital gains tax rate, we have to offset it by raising the personal income tax rate. In other words, if we are going to help the economy in one way, we must hurt it in another. Otherwise, the rich will benefit too, along with the rest of us.

The Tenth Commandment is, "thou shalt not covet." I don't see any great achievement in a tax bill that strikes a 50–50 deal with covetousness I don't see why we should establish our tax code on covetousness. A good tax code is one that doesn't have an ounce of covetousness in it. Considering the ungodly nature of us humans, that might be hard to accomplish, but there is no reason we shouldn't try.

The opportunity to truly reform our tax system was lost in the 1986 tax reform legislation. One group used the bill to close "tax loopholes" in blind pursuit of their goal of "fairness," using a definition altogether lacking in merit. Others simply wanted a revenue-neutral bill that would lower tax rates in order to demonstrate a second major Reagan success.

For their part, economists focused on the improved economic efficiency that would be achieved by abolishing differential "tax preferences," or "loopholes" that distort the choice or mix of investments, and they completely missed the larger issue: The most serious bias in our tax code results from the multiple taxation of saving, which reduces the overall rate and level of investment.

As a consequence of the multiple taxation of saving, the rate of return that an individual realizes from his investment is substantially smaller than the economic return of the investment to society. The amount of money he has to invest is first reduced by the personal income tax. If he invests his after-tax savings in a corporation which uses them to purchase capital equipment, the income earned by the capital investment itself is subject to taxation. First the return from this investment is taxed at the corporate rate, and if the remainder is passed on in the form of a dividend, it is taxed as regular income at the personal rate. If, instead, the remainder is reinvested, the return will be capitalized in the worth of the stock, adjusted for future corporate taxation. If the individual were to sell the stock and realize a capital gain, then this amount is subject to further taxation. These multiple layers of taxation are further compounded by such taxes as the property tax, resulting in reduced investment and lower growth in labor productivity.

Specific investment incentives, such as the investment tax credit and what is called a capital gains differential, can distort the choice of investments. However, they also reduce the tax bias against saving and investment. A reform that sets out, as the 1986 bill did, to eliminate distortions that affect the mix of investments can easily do so in a way that increases the bias against the overall level of investment.

Consequently, the cost of capital would rise and frustrate the expectations of better performance from efficiency gains. This important consideration was neglected in the tax reform bill until the last minute when this Committee, in its wisdom, further reduced the personal and corporate tax rates in order to avoid a substantial increase in the cost of capital.

The 1986 tax bill did not reduce the tax bias against saving, nor did it make the tax system neutral or fair in its treatment of investment. Indeed, the bill's contribution to the economy might not be enough to compensate for the two year hiatus in investment while the economy waited for the legislative outcome of the tax reform debate.

Mr. Chairman, members of the Committee, there is no doubt whatsoever that the capital gains tax affects the cost of capital. Anyone who doubts this should be prepared to raise the capital gains tax to 100 percent.

The capital gains tax is only one element in the cost of capital. It would help to lower it, but not if it is offset by hiking some other element in the cost of capital.

More importantly than how it affects the cost of capital, the capital gains tax affects our human capital by its energizing impact on the incentive to take risk. There are a variety of silly arguments that try to cover up this connection, such as "money for venture capital comes from tax-exempt entities unaffected by the capital gains tax rate." Yes, it often does, but the organizers of the ventures are taxpayers. Pension funds don't dream up new inventions and new technology. On this point see Appendix 2.

If you are concerned with the dispersion or loss of our technology, you might also consider that in today's international economy, the location of high risk new technology will be affected by the international taxation of capital gains. Not entirely, of course, but on the margin. On this point see Appendix 3.

The margin is important. Since World War II the margin we have held over the rest of the world has been shrinking. This process is accelerating as Europe unifies, as the Far East becomes a center of economic power, and as communist countries repudiate an envy-driven economy policy. If we allow envy to drive our tax policy, we will deserve to be the second-rate country we will become.

APPENDIX 1

The erroneous claim is often made that the rich are the primary beneficiaries of capital gains. This claim relies on a peculiar definition of rich—a definition devised to include the capital gains when, for example, a middle class businessman retires and sells his business. That year the capital gain swells his income to several hundred thousand dollars, and he is "rich" for that year. The next year his income goes back down to middle class levels, and someone else sells a business, becoming rich for a year.

Internal Revenue Service data show that people with *recurring* annual income below $20,000 receive a larger proportion of capital gains than those earning over

$200,000. Moreover, 50% of all capital gains go to people earning less than $60,000 annually.

The average capital gain of the 2.9 million taxpayers with recurring income below $20,000 who reported capital gains was $15,147. This average is far too low to support a claim that any significant proportion of these taxpayers are rich people avoiding taxes on their other income.

In contrast, the average capital gain of taxpayers reporting capital gains in the recurring income class of over $200,000 was $265,189. The rich people receiving capital gains are exactly where you would expect them, not hidden away with the poor.

Who are these low income people with capital gains income? Widows and retired couples living off savings, children being educated with the proceeds of a deceased parent's estate, capital gains from the piecemeal sale of property or a business.

Enclosure

Capital Gains By Recurring Income: 1985

INCOME GROUP ($thous)	CAPITAL GAINS ($bil)	PERCENT OF ALL GAINS	PEOPLE W/GAINS (thous)	TOTAL PEOPLE IN CLASS (thous)	AVERAGE CAPITAL GAINS
0 - 10	35.30	20.79	1,485	33,504	$23,771
10 - 20	8.90	5.24	1,433	25,668	$ 6,211
20 - 30	10.70	6.30	1,206	16,465	$ 8,872
30 - 40	10.10	5.95	1,122	11,434	$ 9,001
40 - 50	11.10	6.54	956	6,842	$11,610
50 - 75	17.50	10.31	1,178	5,516	$14,855
75 - 100	12.50	7.36	478	1,231	$26,150
100 - 150	13.10	7.71	272	630	$48,161
150 - 200	8.70	5.12	103	189	$84,466
200 +	41.90	24.68	156	241	$265,189

source: Internal Revenue Service, 1985 Individual Tax Model File, Public Use Sample

Appendix 2

The two tables below are drawn from an empirical study by Dr. John Freear and Dr. William Wetzel, University of New Hampshire. Their paper was prepared for the Babson Entrepreneurship Conference in Calgary, Alberta, Canada in May 1988.

Their evidence shows that individuals provide the bulk of the money for small capitalization new technology firms. Individuals also provide most of the seed and start-up funds for new technology firms.

Financial Rounds of Capital Invested in New Technology - Based Firms

Size of Round	Private Individuals (% of total)		Venture Capital Funds (% of total)		All Other Sources (% of total)		Total	
Less than $250,000	102	(84%)	8	(6%)	12	(10%)	122	(100%)
$250,000-$499,000	43	(58%)	14	(19%)	17	(23%)	74	(100%)
$500,000-$999,000	15	(26%)	31	(55%)	11	(19%)	57	(100%)
Greater than 1 million	17	(9%)	120	(63%)	55	(28%)	192	(100%)
Total	177		173		95		445	

Rounds of Capital Invested in New Technology - Based Firms

Stage of Financing	Private Individuals (% of total)		Venture Capital Funds (% of total)	
Seed	52	(29%)	11	(6%)
Start-up	55	(31%)	38	(22%)
First Stage	29	(16%)	56	(32%)
Second Stage	26	(25%)	46	(27%)
Third Stage	10	(6%)	19	(11%)
Bridge	5	(3%)	3	(2%)
Total	177	(100%)	173	(100%)

Appendix 3

Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investments in 1987

COUNTRIES INDUSTRIALIZED	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States (A)	38.5%	28%	> Six Months	None
Australia (B)	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (C)	17.51%	17.51%	None	None
France (D)	16%	16%	None	None
Germany (E)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	45%	18%	Two Years	.3%
United Kingdom (F)	30%	30%	None	None
PACIFIC BASIN				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

* State, provincial and local tax rates not included.

(A) As of January 1, 1988, the nominal tax rate for long- and short-term capital gains rate is to 28 percent. The marginal rate, however rises to 33 percent for joint returns between $71,980 and $149,250 and for single returns between $43,150 and $89,560.

(B) The above maximum long- and short-term rates are comprised of 1.25% Medicare Levy and 49% Income Tax. Prior to July 1, 1987, the Medicare Levy will remain at 1.145% and the Income Tax will remain at 57.08% (aggregating 58.225%). There is no distinction in rate, however, the one-year holding period is for special exemption and indexing.

(C) Canadian residents are allowed an annual capital gains exemption of Canadian 30,000 ($22,998[1]) subject to a cumulative exemption of up to Canadian 500,000 ($383,300[1]) in 1990.

(D) Gains from proceeds of up to FF 272,000 ($45,288[1]) are exempt from taxation in a given taxable year.

(E) The first DM 1,000 ($554[1]) of short-term capital gains is exempt from tax.

(F) The first £6,300 ($10,096[1]) of annual gain is exempt.

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[1] Based on exchange rates as of March 31, 1987.

Source: Prepared by Arthur Andersen & Co. for the Securities Industries Association.

PREPARED STATEMENT OF DENNIS E. ROSS

Mr. Chairman and Members of the Committee: I appreciate this opportunity to speak with you today about the Administration's proposal to reduce the rate of tax on long term capital gains. The President's Budget for fiscal year 1990 includes a number of proposals that affect revenues, but none that is more important to the continued health of the economy and our future competitiveness. In my testimony today I will explain the tax and economic policy objectives that support the Administration's proposal and how the proposal relates to and is consistent with the objectives of tax reform.

I will also explain the basis for our estimate of the proposal's revenue effects. We recognize that this aspect of the debate over the proper tax treatment of capital gains is highly controversial. We accept, moreover, that reasonable minds can differ over the revenue effects of a cut in the capital gain rate. At the same time, we believe a careful review of the available evidence supports Treasury's estimate that the proposal raises revenue in the budget period and in the long run. Accordingly, we have supplied an unprecedented amount of information concerning the basis for our estimate. If these hearings produce no more than a careful examination of the issues involved in estimating a reduction in capital gain rates, we will have advanced debate over an important issue of tax policy and I believe also increased the chances that a capital gain preference will be restored.

THE ADMINISTRATION'S PROPOSAL

In general, the Administration's proposal would allow individuals to exclude 45 percent of the gain realized upon the disposition of qualified capital assets. The maximum tax rate applicable to any gains on qualified assets would be 15 percent. A qualified asset would generally be defined as any asset that qualifies as a capital asset under current law and satisfies the phased-in holding periods. For example, assuming the holding period is satisfied, an individual's residence would be a qualified asset and gain on its disposition would be eligible for the lower capital gains rate as well as the continued rollover of gain and the $125,000 one-time exclusion provided under current law.

Disposition of a qualified asset by a RIC, REIT, partnership, or other passthrough entity would continue to be treated as capital gain under the proposal and would be eligible for the exclusion in the hands of individual investors.

Holding Period and Effective Date. To be treated as qualified assets eligible for the lower capital gains rate, assets will need to satisfy the following holding periods: more than 12 months for assets sold in 1989, 1990, 1991, and 1992; more than 24 months for assets sold in 1993 and 1994; and more than 36 months for assets sold in 1995 and thereafter.

The proposal would be effective generally for dispositions of qualified assets after June 30, 1989. Dispositions of qualified assets after that date would be fully protected by the exclusion or maximum rate. That is, there would be no blended rate for gains realized in 1989 after June 30. Conversely, gains realized on or before June 30, 1989, would not be eligible for the exclusion, maximum rate, or any of the other provisions of the proposal and would be taxable under current law.

Installment sales, including sales preceding the effective date, would be eligible for the preference to the extent installments were realized after the effective date.

15 Percent Maximum Rate. A 15 percent maximum tax rate would apply to capital gains on qualified assets. Thus, while a taxpayer's ordinary income may be subject to a 33 percent marginal rate (due to phase-out of the 15 percent rate or personal exemptions), capital gains would not be subject to a marginal rate exceeding 15 percent. In some cases, the application of a 45 percent exclusion would result in an effective tax rate lower than 15 percent; for example, if the taxpayer's marginal rate is 15 percent, a 45 percent exclusion would result in an effective tax rate of 8.25 percent.

100 Percent Exclusion for Low Income Taxpayers. A taxpayer would be eligible for a 100 percent exclusion on sales of qualified assets if the taxpayer's adjusted gross income is less than $20,000 and the taxpayer is not subject to the alternative minimum tax. The $20,000 amount would be calculated taking the 45 percent capital gains exclusion into account. Thus, if a taxpayer's adjusted gross income is $22,000 (including the full amount of gains realized on capital assets), and a 45 percent exclusion on capital gains would reduce the taxpayer's taxable income to less than $20,000, the taxpayer would be eligible for the 100 percent exclusion.

The $20,000 figure applies to married taxpayers filing jointly and to heads of households. Single taxpayers and married taxpayers filing separately would be eligible for the 100 percent exclusion if their adjusted gross incomes are less than $10,000.

Relationship to the AMT. Taxpayers who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion. In making this determination, a taxpayer's tentative minimum tax would be compared with his regular tax computed using a 45 percent exclusion. If the tentative minimum tax exceeds the regular tax, the taxpayer has liability under the alternative minimum tax and would not be eligible for the 100 percent exclusion. The ineligibility for the 100 percent rate would have no other effect on the taxpayer.

Collectibles Not Treated as Qualified Assets. The proposal would deny capital gain treatment for gains realized upon the disposition of collectibles, as defined under the individual retirement account (IRA) rules. These rules prohibit investments by IRAs in collectibles, which are defined to include works of art, rugs, antiques, precious metals, gems, stamps, alcoholic beverages, and most coins. The Secretary of the Treasury is also given authority to specify other tangible personal property to be treated as collectibles. Proposed regulations define collectibles to include musical instruments and historical objects.

Depreciable Assets. The Administration's proposal would not alter the definition of a capital asset; however, gain from the sale, exchange, or other disposition of depreciable or depletable property used in a trade or business would not be treated as gain eligible for the lower capital gains rates. For this purpose, depreciable property refers to any property which is of a character subject to an allowance for depreciation under Code sections 167 or 168. Thus, gains realized on the disposition of intangible property, the cost of which may be recovered through amortization deductions (see Treasury Regulation Section 1.167(a)–3), such as sports player contracts, would be treated as ordinary income if the intangible property is used in the taxpayer's trade or business. The fact that cost recovery of an Intangible asset may be referred to as "amortization" would not prevent its being treated as depreciable property under this provision. Depletable property refers to any property of a character that is subject to an allowance for depletion, whether cost or percentage depletion.

Under current law, gains on dispositions of special section 1231 assets, which include certain interests in timber, coal, iron ore, livestock, and unharvested crops, are eligible for capital gain treatment while losses on such property are ordinary losses. Under the Administration's proposal, no assets would be afforded such asymmetrical treatment.

Gains on nondepreciable property that is used in a trade or business and is not held for sale in the ordinary course of business would be eligible for the lower capital gains rates. Losses on such property would also be treated as capital losses. Thus, for example, gain or loss realized on the disposition of land that is used in a trade or business and is not held for sale to customers would be treated as capital gain or loss.

Capital Losses. Capital losses would be defined as under current law; however, each dollar of long-term capital loss that does not offset long-term capital gain could offset only 50 cents of noncapital gains income, as was the case prior to 1987. The $3,000 capital loss limitation would remain. Unused capital losses could be carried over indefinitely.

Preventing Abuses. Special rules will be included in the legislation to prevent abusive shifting of capital gains from high income taxpayers to related low income taxpayers in order to qualify for the 100 percent exclusion, designed for true low and moderate-income taxpayers. For example, the 100 percent exclusion might be denied to individuals recently claimed as a dependent on the return of another taxpayer.

Because the proposal provides favorable tax treatment to sales of corporate stock, without regard to whether the assets held by the corporation are qualified assets, it may also be necessary to adopt rules preventing the use of a corporation as a vehicle to convert ordinary income to capital gain. For example, it could be appropriate to restrict or deny altogether capital gain treatment on sales of S corporation stock, leaving shareholders to recognize any capital gains through sales of the S corporation's assets.

REASONS FOR THE PROPOSAL

Encourage Long-Term Investment. A capital gain preference has long been accepted as an important incentive for capital investment. In our own country, the first tax rate differential for capital gains was introduced by the Revenue Act of 1921. For each of the next 65 years there was always some tax differential for capital gains. At times there was an exclusion of some portion of the nominal gains. At times there was a series of exclusions that depended upon the length of time a taxpayer held an asset before selling. At times there was an alternate tax rate cap. But at no time subsequent to 1921 and prior to 1987 were capital gains ever taxed the same as ordinary income.

Our major trading partners have similarly recognized the importance of the capital gain preference. Canada, Japan, Germany and the United Kingdom all provide some level of preferential treatment for capital gains.

The Administration's proposal further adds to the incentive effects of the capital gain preference by targeting it to long-term investment. Currently, investors receive the same tax treatment whether they hold an asset for 10 years or 10 minutes. If this country is to maintain its leadership role in the world economy, we need to encourage investment, and, in particular, investment that is oriented to long-term growth rather than short-swing, speculation. By orienting investors more towards the long term, we will also enable and encourage corporate managers to take the long view of their companies' businesses, and to make the investment in research and development needed for success in future markets.

Lock-In Effect. Under a system in which capital gains are not taxed until "realized" by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Thus, taxpayers who, independent of tax considerations, would convert their existing assets to new investments may instead hold on to their investments to avoid paying tax on any accrued gains.

This so-called lock-in effect of capital gains taxation has at least two adverse effects. First, it produces a misallocation of capital in the economy since it alters the investment decisions that would be made in a genuinely free market. Second, the lock-in effect, depending on its strength, may deprive the government of revenue. To the extent taxpayers defer sales of existing investments, or hold onto such investments until their death, taxes that might otherwise have been paid are deferred or avoided altogether. The combination of these two effects produces a situation in which both the taxpayer and the government lose. The taxpayer is discouraged from pursuing what he believes is a more attractive investment and the government loses revenue.

Although some lock-in effect exists at any positive rate of tax on capital gains income, a preference for long term capital gains diminishes its adverse effects. The 45 percent exclusion proposed by the Administration would both improve the allocation of investment capital and trigger enough additional realizations to produce a net revenue gain to the Treasury.

Inflation. Although inflation has been kept low under policies of the past 8 years, even low rates of inflation mean that every nominal capital gain includes a "fictional" element of profit attributable to inflation. High rates of inflation, such as those that existed in the mid and late 1970s, exacerbate the problem.

Ideally, an income tax would consider only "real" changes in the value of capital assets; the element of nominal gain attributable to inflation would be disregarded. Current law taxation of nominal capital gains in full has the perverse result that real gains are overstated (and taxed too highly) and real losses are understated and, in some cases, actually converted by inflation from losses to gains. The Administration's proposed 45 percent exclusion for long-term capital gains would provide a rough adjustment for the inflationary element of capital gains. Although not a conceptually perfect response to the problem of inflation, this rough adjustment avoids the complexities and additional record-keeping that a precise inflation adjustment would require.

Low and Moderate Income Taxpayers. Low and moderate income individuals typically do not realize capital gains of the same size or with the same frequency as higher income taxpayers. It is not true, however, that only high income taxpayers would benefit from a capital gains tax rate differential. Although a large percentage of capital gains is realized by high income taxpayers, most taxpayers who would benefit from the Administration's proposal have low and moderate incomes. In 1985, the latest year for which detailed tax return data have been analyzed, one-third of all tax returns with long-term capital gains reported other (noncapital gain) income of less than $20,000. Nearly three-fourths of all tax returns with capital gains had other income of less than $50,000. And less than 2 percent had other income of $200,000 or more. (See Table 1.)

Economic studies of the behavioral reactions of individuals to changes in the taxation of capital gains suggest that lower income individuals are less responsive than higher income taxpayers to capital gains tax rate changes. The Administration's proposal for a 100 percent exclusion for lower income taxpayers provides such taxpayers with an extra measure of incentive to make direct capital investment.

Collectibles. Investment in so-called collectibles, which include works of art, stamp and coin collections, antiques, valuable rugs, and similar items does relatively little to enhance the nation's economic growth or productivity. For this reason collectibles do not warrant the preferential treatment accorded other capital investments.

Treatment of Gain on Depreciable Property. Depreciable property sales are not particularly sensitive to changes in the tax rate. The timing of such sales is more likely to be determined by the condition of the particular asset or by routine business cycles of replacement than would be true of capital assets held by investors. Thus, unlike a preferential rate for investor held capital assets, a preferential rate for sales of depreciable assets could not be justified as offsetting a strong lock-in effect and would lose rather than gain revenue. Correspondingly, the case for extending a capital gain preference to depreciable assets would have to rest substantially on the incentive effects of the preference.

The tax system has historically provided incentives for investment in depreciable and depletable property through the cost recovery system. For example, current law allows investment in plant and equipment to be recovered on an accelerated basis, permits percentage depletion for a broad range of natural resources, provides special treatment for the costs of raising timber, and has a variety of special rules under which the cost of certain intangibles may be amortized. An additional incentive in the form of a capital gain preference is at this time neither necessary nor appropriate.

Moreover, the availability of accelerated cost recovery coupled with capital gain treatment on sales of depreciable or depletable property has been a major factor behind tax shelter activity. Although the passive loss rules adopted in the 1986 Act limit tax shelter activity, restoration of a capital gain preference could make tax shelters more attractive.

Finally, gains and losses from sales or other dispositions of depreciable and depletable property should be treated in the same manner as other business income or loss and gains or losses from sales of other business property (e.g., inventory). The asymmetrical treatment of gains and losses from such depreciable or depletable property provided by pre-1987 law, i.e., the availability of capital gain treatment for gains and ordinary loss treatment for losses, is without justification as a matter of tax policy.

EFFECTS OF PROPOSAL ON REVENUES

As I stated earlier, the effect on Federal tax revenues of changes in capital gains tax rates is highly controversial. Studies using different data, different explanatory variables, and different statistical methodologies have reached different conclusions. Our estimate was made after a careful review of empirical studies by experts in government and the academic community. Our estimate of induced realizations attempts to approximate a consensus from an admittedly wide range of results.

Before analyzing our estimate in detail, allow me to make one point about its source. The revenue estimates reported in the budget were produced by Treasury's Office of Tax Analysis, the same Treasury office that provides revenue estimates for all other legislative and budget proposals. You may have seen press reports that other offices in Treasury determined the estimates or that the Office of Tax Analysis produced them with the proverbial gun to its head. Whether the product of misinformation or fevered imagination, such reports are simply wrong. Although there has been a debate for some time at Treasury as to the proper basis for estimating changes in the capital gain rate, the simple fact is that these estimates reflect the same basic assumptions the Office of Tax Analysis has used for a number of years in analyzing capital gains proposals.[1]

Consistency with Prior Estimates. Perhaps the best place to start in analyzing the current estimate is with Treasury's estimate of the 1986 Act changes in capital gain taxation. Many have asked how Treasury could score restoration of a capital gain preference as raising revenue when it scored the elimination of the preference in the 1986 Act as raising revenue. The short answer to that question is that the current proposal does not simply reverse the changes made in the 1986 Act. When fully phased-in, the budget proposal limits the preference to nondepreciable assets with a 3-year holding period. This effectively targets assets that are more likely to be sold in response to a lower tax rate, and turns the budget proposal from a revenue loser in the long run to a long run revenue gainer.

One factor that masks the consistency in Treasury's estimates is that our published estimate of the 1986 Act capital gain change includes revenue not actually attributable to the elimination of the capital gain preference. Prior to the 1986 Act, there was a 30 percentage point differential in the rates of tax applicable to capital gains and other income (i.e., a 50 percent maximum rate on ordinary income and a 20 percent maximum rate on capital gains). That differential created a large incentive for taxpayers to convert ordinary income to capital gains. Elimination of the differential eliminated incentives for income shifting and consequently raised substantial revenue.

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[1] The general realization response estimated for both the 1986 Act and this proposal is midway between the time-series and panel cross-section estimates published in the 1985 Treasury study of capital gains.

Although our published estimates attributed all of the revenue gain from reduced income shifting to the capital gain proposal, the greater part of it was in fact a result of the reduction in ordinary rates from 50 to 28 percent. Thus, even if the 1986 Act had left capital gain rates at 20 percent, the reduction in the ordinary rates would have substantially reduced the capital gain differential and resulted in a revenue pick-up from diminished income shifting. By including that revenue pick-up in the line estimate of the capital gain change, the positive revenue effects of that proposal were substantially overstated. If that estimate were restated, backing out the effect of the reduction in ordinary income rates, the capital gain rate increase raised only modest revenue in the long run.

Revenue Effects of Proposal's Separate Elements. Table 3 shows the separate revenue effects of the various elements of the capital gains proposal. In addition, it shows the "static" and behavioral effects incorporated in the estimate. Additional revenues resulting from positive macroeconomic effects, i.e., revenue effects from an increase in economic growth and productivity, are not included in the revenue estimate. I will address the macroeconomic revenue impact later.

1. *Effect of Tax Rate Reduction on the Level of Current Law Realizations.* Row 1 of Table 3 states the revenue loss that results from reducing tax rates on capital gains that would be realized at current law tax rates; i.e., realizations that would have occurred regardless of a reduction in tax rates. This loss is what a truly "static" revenue estimate would show. This "static" revenue loss results from applying the proposal to all assets held 1 year or longer and is estimated to be $ -11.9 billion in fiscal year 1990 and to be about $ -20 billion a year and growing gradually thereafter.

The basis for these calculations is reflected in Table 4, which shows that about $150 billion of net long term capital gains will be realized in 1989 and that this amount will grow to about $200 billion by 1994 with no change in law. Because the Treasury had estimated a greater behavioral response to the 1986 Act change than did the staff of the Joint Committee on Taxation, it is our understanding that the Joint Committee on Taxation staff assumes a somewhat higher path of realized gains under current law and hence a somewhat larger "static" revenue loss.

2. *Effect of Increased Realizations.* The second row of Table 3 shows the revenue collected from realizations that would not occur absent the lower tax rate. These induced gains are accelerated from realizations in future years, are due to portfolio shifting to capital gain assets from fully taxable income sources, or are taxable realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charities, or realized but not reported.

As indicated by a comparison of Rows 1 and 2, we estimate that revenues from induced realization gains more than offset the revenue loss from lower rates on current gains. This conclusion is based on the assumed responsiveness of taxpayers to changes in the capital gain rate, which is in turn the central and most controversial aspect of the debate over capital gains and revenue.

The level of taxpayer responsiveness is generally termed "elasticity," which in this context is shorthand for the expression "percentage increase in induced capital gains divided by the percentage decrease in the overall capital gains tax rate." Thus, a tax cut will tend to generate a revenue increase if the elasticity is estimated to be greater than 1, no change in revenue if the elasticity is exactly 1, and a revenue loss if the elasticity is less than 1.[2]

Our assumption about capital gain elasticities is based on a review of government and academic studies examining the question. A cursory evaluation of these studies, which are listed in Table 5, reveals that those carried out with so-called cross section data or panel data (examining individual taxpayers in a given year or for several years) tend to yield higher estimates of taxpayer responsiveness than those carried out with time-series data (examining taxpayers in the aggregate for a number of years). Giving consideration to studies of both types, we believe that the elasticity estimates used by Treasury are comfortably in the middle of. the range reported in the studies. We estimate an elasticity of 1.2 in the short run, dropping to about 1.0 in the long run, and to about 0.9 after considering the impact of converting ordinary income but before targeting the proposal for certain kinds of assets. It is our understanding that estimates made by the staff of the Joint Committee on Taxation employ a much lower long-run estimate—perhaps as low as 0.7—which is within the range of the studies, but in our view clearly at the lower end. This difference in elasticities, which may seem relatively small, accounts for the great bulk of the difference between the Treasury and the Joint Committee on Taxation estimates.

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[2] Even this general statement will not always be accurate. An elasticity for reduced capital gains realizations that is slightly less than 1 generally will still generate a revenue increase because taxpayers paying the highest tax rates are the most responsive. Induced realizations are disproportionately distributed with more being taxed at above-average tax rates and fewer being taxed at below-average tax rates. In addition, the general statement will not be accurate for studies using "last dollar" or maximum statutory rates.

Table 4 shows that for the Administration's basic proposal (i.e., before targeting assets, extending the holding period to 3 years, and providing additional low income tax relief) the estimated amount of induced realizations is large: $167 billion in 1991, nearly doubling the amount of gains that would have been realized with no change in law. By 1995, induced realizations would be expected to level off at about 87 percent of the level of current law capital gains realizations.

This near doubling of realizations, from an estimated $183 billion to about $349 billion at 1989 levels, may seem remarkably optimistic until it is placed in the following perspective.

- The total accumulation of unrealized qualifying gains at the end of 1987 was an estimated $4 trillion. That's trillion, not billion.
- If we exclude from this figure gains on personal residences, which largely escape tax because of the rollover and one-time $125,000 exclusion, the total pool of gains that could be realized is still $2 trillion.
- The year-over-year increase in this accumulation—a good guide to the potential long-run realizations—has been running about $350 billion per year, even with personal residences excluded, and is expected to grow.

3. *Effect of Deferring Gains Until After Effective Date.* Row 3 of Table 3 shows that the proposal will induce some taxpayers to defer realizations in the first half of 1989 until after the effective date of the proposal. With the announcement of the proposal in February and the assumed enactment and effective date of July 1, 1989, some realizations that otherwise would occur between the announcement date and the effective date will be delayed in order to benefit from the lower tax rate. The estimate predicts that about $1.4 billion of revenue will be lost only over the fiscal year 1989–1990 period due to realizations deferred until the effective date.

4. *Effect of Conversion of Ordinary Income to Capital Gain Income.* The proposal will induce taxpayers to realize additional capital gains currently and will encourage taxpayers to earn income in the form of lower taxed capital gains. Since the advent of preferential tax rates on capital gains in 1922, taxpayers have found various ways to convert ordinary taxable income into capital gains. Many of the most obvious conversion techniques have been stopped, but a capital gains tax rate differential will encourage taxpayers to shift to sources of income with lower tax rates.

Methods of converting ordinary income to capital gain income include shifting away from wages and salaries to deferred compensation, such as incentive stock options; shifting out of fully taxable assets, such as certificates of deposit, to assets yielding capital gains; and shifting away from current yield assets to growth assets, including corporations reducing their dividend payout ratios. It is assumed that the conversion of ordinary income to capital gain income will occur gradually, increasing from a negligible amount in 1991 to about $2.5 billion by the fifth year.

5. *Effect of Excluding Depreciable Assets and Collectibles.* The revenue estimate of the proposal is significantly affected by the exclusion of depreciable assets and collectibles from the lower rate. The 1985 Treasury study of capital gains found the responsiveness of capital gain realizations from assets other than corporate shares to be relatively low.[3] That is, for some classes of assets the additional tax from induced realizations will not offset the tax loss from lower tax rates on gains that would occur under current law. By restricting the lower rates to more responsive assets, the proposal raises an incremental amount of additional net revenue, $1.2 billion in 1990, rising to $2.1 billion by 1994.

6. *Effect of Phasing In the 3-Year Holding Period Requirement.* The 3-year holding period requirement is phased in gradually beginning in 1993. Any holding period encourages taxpayers to defer realizations until they are eligible for the lower rate. During the transition to the 3-year holding period, a one-time revenue loss will

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[3] The estimated elasticity from panel cross-section data was .07 for corporate shares, 0.71 for residential rental real estate, and 0.43 for all other assets.

occur as realizations are deferred. After the transition is completed, the 3-year holding period raises revenue because it, like the depreciable asset exclusion, tends to limit the lower rate to assets more responsive to changes in capital gains tax rates. Assets sold after only 1 or 2 years for consumption or other purposes, rather than deferred to 3 years, would generally be less responsive to lower tax rates.

The phase-in of the 3-year holding period will encourage many taxpayers to defer realizations that would otherwise occur after 1 or 2 years until they become eligible for the lower tax rates. In addition, the phase-in will provide an incentive during the transition for some taxpayers to accelerate the realization of some gains. For instance, taxpayers who might realize gains held for 18 months in early 1993 might choose to accelerate those gains into calendar year 1992 to be eligible for the lower rate as 1-year assets. Thus, the phase-in will increase realizations in 1992 and revenues in fiscal years 1992 and 1993. Due to the two-step phase-in (the jump to 2 years in 1993 and to 3 years in 1995), the revenue pattern creates temporary incremental revenue losses in fiscal years 1994 and 1996. By 1998, the long-run effect of imposing a 3-year holding period is a revenue increase of $1.5 billion.

7. *Effect of 100 Percent Exclusion for Low-Income Taxpayers.* The additional provision to exclude all qualified capital gain realizations from tax for taxpayers with low incomes will lose approximately $0.3 billion annually. In 1985, taxpayers with adjusted gross incomes of less than $20,000 accounted for 30.2 percent of returns with capital gains and 11.4 percent of net long-term capital gain realizations. Some of these taxpayers, however, were taxpayers with low adjusted gross income due to large tax preferences. The potential cost of this feature is reduced by limiting the zero tax rate to individuals who are not subject to the alternative minimum tax rate. The provision is considered after the initial 45 percent exclusion so the revenue loss is due only to the rate reduction from 8.25 percent (55 percent times 15 percent) to zero, not the full reduction from 15 percent to zero.

Total Effect of the Proposal. The Administration's proposal is estimated to increase Federal revenues in fiscal years 1989 through 1993 due to the large induced realizations in the initial years from the unlocking of previously accrued gains. During fiscal years 1994 through 1996, a one-time revenue loss will occur as the 3-year holding period requirement is phased in, causing taxpayers to defer short-term realizations. After fiscal year 1997, the proposal will increase Federal receipts between $1 and $2 billion annually.

COMPARISON OF TREASURY AND JOINT COMMITTEE ON TAXATION ESTIMATES

Table 6 summarizes the principal differences between the Treasury estimate of the revenue impact and the Joint Committee on Taxation staff estimate. In order to isolate the various effects in a comparable way, it is necessary to combine four rows of the more detailed Treasury revenue table and two rows of the Joint Committee table.

As discussed above, the main difference between the Treasury revenue estimate and the revenue estimate made by the staff of the Joint Committee on Taxation is that the latter estimate assumes a lower level of responsiveness by taxpayers. This difference shows up in the first bank of numbers on Table 6. A second and related difference appears in the third bank of numbers, dealing with the phase-in of a 3-year holding period. The Treasury estimate assumes a good deal of shifting on the part of taxpayers delaying and accelerating certain sales as the holding period is stretched out, while the Joint Committee on Taxation staff estimate assumes less responsiveness to shifting realizations around effective dates.

MACROECONOMIC IMPACT OF THE PROPOSAL

Our revenue estimates of the Administration's proposal do not include potential increases in the rate of macroeconomic growth expected from a lower capital gains tax rate. This conforms to the general budget practice of including macroeconomic effects of revenue and spending proposals in the underlying economic forecast and hence the budget revenue and outlay totals, but excluding such effects from budget lines showing revenue impacts of any particular proposal. In the case of the proposed lower capital gains tax rate, the investment, savings, and national income growth will be most significant over the longer term.

There are two ways the Administration's capital gains proposal would affect growth. First, a lower tax rate on capital gains that qualify under the Administration's proposal would mean a lower cost of capital, primarily on corporate sector investment. Since these investments incur higher than average taxes under current law, the proposed change helps promote a more efficient playing field. By itself, this more efficient allocation of capital among sectors would improve economic welfare and lead to higher growth.

Second, by lowering the cost of capital generally, the proposal would encourage more savings and investment, leading directly to greater capital formation and eventually to a higher rate of growth in the economy.

One possible approach to quantifying the long-run macroeconomic effects would be to employ the kind of models and techniques that were used by Treasury to evaluate long-run macroeconomic consequences of tax reform. As an illustration, if we assume a 4 percent constant long-run rate of inflation and a 4 percent after-tax real rate of return required by investors, these models suggest that the Administration's proposal could increase real national income by between 0.2 percent and 0.4 percent after the economy fully adjusts. This, in turn, would translate into a permanent annual increase in long-run tax revenues of about $3 billion to $5 billion in real 1989 terms. This revenue increase would be in addition to that reflected in the budget estimate which I have discussed above.

CONSISTENCY WITH TAX REFORM

Many appear to oppose a reduction in the capital gains rate for fear that it would reopen tax reform. They argue that the elimination of the capital gains preference was a basic trade-off in exchange for lower tax rates on other income. On this view, restoring the capital gain preference would either leave the system biased in favor of wealthy taxpayers or lead inevitably to an increase in the rate of tax on other income.

The low marginal tax rates established in tax reform were an achievement of historical significance, and plainly should not be jeopardized. Although we should thus be appropriately cautious in reexamining decisions made in tax reform, the ultimate test must be whether, consistent with the principles underlying tax reform, a proposed change in the tax law improves the efficiency and fairness of the tax system. Most accept that a capital gain preference has positive effects on economic efficiency, but we believe it is also consistent with distributional fairness.

In the first place, our estimates show that the lower capital gain rate will generate more tax revenue from wealthy taxpayers. It is difficult to argue that a proposal that increases the tax liabilities of the wealthy biases the system in their favor.

Nor do we think this conclusion is inconsistent with the premises of the 1986 Act. As I stated earlier, the Administration's proposal raises revenue precisely because it is not a simple reversal of the changes made in 1986. The capital gain preference would be restricted to a smaller pool of assets, with the preference denied to the assets historically used in tax shelters. In addition, taxpayers will be required to hold their investments for a substantial period, with the preference denied to short-swing, speculative activity.

Finally, as this Committee well knows, the 1986 Act was more complex than a simple trade of lower rates of tax on ordinary income for an elimination of the capital gain preference. Tax reform also involved substantial base broadening, the impact of which landed disproportionately on affluent taxpayers. Even more fundamentally, tax reform involved a substantial transfer of tax burden from the individual to the corporate sector, none of which was factored into the analysis of the legislation's distributional effects. In that context, the addition of a capital gains tax rate, limited primarily to holders of corporate stock, cannot fairly be seen as undermining the progressivity of the tax income system.[4]

CONCLUSION

In sum, we believe the case for the Administration's capital gain proposal is compelling. The proposal will provide an important incentive for long-term savings and investment, which over time will boost productivity and economic growth. Importantly, this incentive comes without cost in revenues, and indeed in our view significantly increases revenues in the budget period and in the long run.

We recognize that for some the possibility that a cut in the capital gain rate could increase revenue is "too good to be true." They dismiss the argument as a fanciful elaboration of supply-side economics. Although such reactions are understandable, they miss the critical point that the capital gains tax rate under current law is elective with taxpayers. Until a taxpayer sells his asset, the rate of tax is zero. Capping the statutory tax rate at 15 percent will cause many taxpayers, who would otherwise elect a zero tax rate by retaining their investments, to realize their gains and pay some tax.

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[4] If tax changes resulting from induced realizations are taken into account along with static changes in tax, the restoration of a capital gains tax rate differential results in a slightly progressive redistribution of taxes. For example, as shown in Table 2, before making adjustments for conversion and targeting, under our basic proposal there would be a 9.2 percent increase in tax for all taxpayers with over $50,000 of adjusted gross income and a 3.1 percent reduction in capital gains tax for taxpayers with less than $50,000 of income.

Finally, let me emphasize Treasury's willingness to provide whatever assistance we can as the Committee examines the Administration's proposal and the tax and economic policy issues it raises. We have attempted in our testimony to lay out in detail the policy basis for the proposal and for our estimate of its revenue effects. We stand ready to supply such additional information as Committee members would find relevant.

That concludes my prepared remarks. I would be pleased to respond to any questions.

Attached Tables and Exhibits:

Table 1 showing the distribution of capital gains tax changes by income class for the basic proposal with induced realizations included.

Table 2 showing the distribution of returns with capital gains by non-gains income class.

Table 3 showing the Treasury estimates in detail.

Table 4 showing the distribution of realizations under current law and under the basic 45%-15% proposal.

Table 5 showing the range of elasticities appearing in various studies by academic and government economists.

Table 6 showing a line-by-line comparison of the Joint Committee on Taxation and the Office of Tax Analysis revenue estimates.

Table 1

Distribution of Net Long Term Capital Gains For Returns With Long Term Capital Gains in 1985

(In Percent)

Adjusted Gross Income Class Without Capital Gains	Distribution of Returns With Long Term Gains	Distribution of Long Term Gains	Percentage of Total Returns With Long Term Gains
Less than $10,000	16.9%	19.7%	5.1%
$10,000 to $19,999	16.5	5.9	6.5
$20,000 to $29,999	15.9	6.1	9.8
$30,000 to $49,999	24.7	12.0	13.6
$50,000 to $99,999	19.7	17.5	24.6
$100,000 to $199,999	4.5	12.6	56.2
$200,000 or more	1.8	26.2	76.1
TOTAL	100.0%	100.0%	9.9%

Department of the Treasury
Office of Tax Analysis

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Source: 1985 IRS Statistics of Income

Table 2

Distribution of Net Capital Gains, and Tax Liability Under Current Law and an Across the Board Rate Cut 1/

(Calendar Year 1991, $Billions)

Adjusted Gross Income Class Under Current Law	Capital Gain Realizations		Tax on Capital Gains	
	Current Law	Rate Cut 1/	Current Law	Rate Cut 1/
Less Than $10,000	19	22	0.9	0.7
$10,000 to $19,999	7	10	0.9	0.7
$20,000 to $29,999	8	12	1.3	1.2
$30,000 to $49,999	15	29	3.3	3.6
$50,000 to $99,999	24	54	6.3	7.5
$100,000 to $199,999	23	50	6.4	6.9
$200,000 or more	86	172	22.2	23.7
TOTAL	182	349	41.3	44.3

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Office of Tax Analysis

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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

Table 3

Revenue Effects of The President's Capital Gains Proposal
Fiscal Years 1989–1999

Effects of Proposal	Fiscal Years ($billions)										
	Budget Period						Longer Run*				
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Effect of Tax Rate Reduction on Existing Gains Projected For Current Law Realizations	-1.6	-11.9	-17.6	-19.1	-20.2	-21.0	-21.5	-22.0	-22.5	-23.0	-23.5
Effect of Increased Realizations	2.4	17.1	21.8	21.8	21.5	22.3	22.3	22.9	23.4	23.9	24.5
Effect of Delaying Gains Until the Effective Date	-0.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effect of Conversion of Ordinary Income to Capital Gain Income	0.0	-0.1	-0.6	-1.3	-1.9	-2.5	-2.5	-2.6	-2.6	-2.7	-2.8
Effect of Excluding Depreciable Assets and Collectibles	0.2	1.2	1.7	1.9	2.1	2.1	2.3	2.4	2.4	2.5	2.5
Effect of Phased in Three Year Holding Period	0.0	0.0	0.0	0.4	1.0	-7.4	-2.3	-11.7	-0.1	1.5	1.5
Effect of 100% Exclusion for Certain Low Income Taxpayers	-0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
TOTAL REVENUE EFFECT OF PROPOSAL	0.7	4.8	4.9	3.5	2.2	-6.8	-2.0	-11.3	0.2	1.8	1.8

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Notes: *These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.*

Details may not add due to rounding.

Disaggregated effects are stacked in sequence.

** Longer run estimates assume 1994 growth extends past the budget forecast period.*

Table 4

Realizations of Net Long Term Capital Gains Under Current Law and an Across the Board Rate Cut 1/

($ Billions)

Tax Year	Realizations Under Current Law	Realizations Under Rate Cut 1/	Change in Realizations Rate Cut 1/
1980	71	--	--
1981	78	--	--
1982	87	--	--
1983	117	--	--
1984	136	--	--
1985	166	--	--
1986	319	--	--
1987 P	140	--	--
1988 E	135	--	--
1989 E	151	288	137
1990 E	168	333	165
1991 E	183	349	167
1992 E	193	357	164
1993 E	201	367	166
1994 E	206	384	178
1995 E	210	393	183
1996 E	215	402	187
1997 E	220	412	192
1998 E	225	421	196
1999 E	230	431	201

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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

'P', Data are preliminary and include short term capital gains.
'E', Estimate.

Table 5

Long-Term Capital Gains Realization Elasticities Derived From Academic and Government Studies

Studies	Data Type	Capital Gains Type	Derived Realization Elasticity	Elasticity Derived by Simulation
Individual Tax-Return Studies:				
Feldstein, Slemrod, and Yitzhaki (1980)	Cross-Section, High-Income Sample, 1973	Corporate Stocks	-3.75	No
Minarik (1981)	Cross-Section, High-Income Sample, 1973	Corporate Stocks	Range from -.44 to -.79	No
Auten and Clotfelter (1982)	Panel Data, Middle-Income Sample, 1967 to 1973	All Capital Assets	Short-Run Range: -.91 to -3.46, Long-Run Range: -.36 to -1.45	No
U.S. Treasury (1985)	Panel Data, 1971 to 1975	All Capital Assets	Long-Run Range: -1.16 to -2.20	Yes
U.S. Treasury (1985)	Panel Data, 1971 to 1975	Corporate Stocks Real Estate Other Assets	Long Run: -2.07 Long Run: -.71 Long Run: -.43	Yes
Aggregate Time-Series Studies:				
U.S. Treasury (1985)	Time Series, 1954-1985, All Taxpayers	All Capital Assets	Short Run: -1.3 Long Run: -0.8	No
Lindsey (1987)	Pooled Cross-Section and Time Series, 1965-1982	All Capital Assets	*Short Run: -2.14 *Long Run: -1.37	No
Darby, Gillingham, and Greenlees (1988)	Time Series 1954 to 1985, All Taxpayers	All Capital Assets	*Long-Run Range: -.62 to -1.55	No
Congressional Budget Office (1988)	Time Series 1954 to 1985, All Taxpayers	All Capital Assets	*Range from -.79 to -.99	No
Auerbach (1988)	Time Series 1954 to 1986, All Taxpayers	All Capital Assets	*Long-Run Range -.06 to -1.08	No

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* Not reported by author(s). Derived at 25.4 percent average tax projected for 1988 by CBO Report (1988), Table 8

Table 6

Treasury and Joint Committee Revenue Estimates
For the President's Capital Gains Proposal

Item	Fiscal Years, $ Billions					
	1989	1990	1991	1992	1993	1994
1. General Proposal 1/						
Treasury	0.6	3.9	3.6	1.4	-0.6	-1.2
Joint Committee on Taxation	0.6	2.4	-6.2	-8.9	-9.8	-11.6
Difference	0.0	-1.5	-9.8	-10.3	-9.2	-10.4
2. Exclusion of Certain Asset Types						
Treasury	0.2	1.2	1.7	1.9	2.1	2.1
Joint Committee on Taxation	0.2	1.3	2.7	2.9	3.1	3.2
Difference	0.0	0.1	1.0	1.0	1.0	1.1
3. 3-Year Holding Period						
Treasury	0.0	0.0	0.0	0.4	1.0	-7.4
Joint Committee on Taxation	0.0	0.0	0.0	0.1	0.3	-1.9
Difference	0.0	0.0	0.0	-0.3	-0.7	5.5
4. Exclusion for Certain Taxpayers						
Treasury	0.0	-0.3	-0.3	-0.3	-0.3	-0.3
Joint Committee on Taxation	-0.1	-0.4	-0.4	-0.4	-0.5	-0.5
Difference	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2
Total Revenue Effect						
Treasury	0.7	4.8	4.9	3.5	2.2	-6.8
Joint Committee on Taxation	0.7	3.3	-4.0	-6.4	-6.9	-10.9
Difference	-0.1	-1.5	-8.9	-9.7	-9.1	-4.0

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1/ Includes the JCT's 45% exclusion and effective date lines, and Treasury's static estimate, increased realizations, delayed realizations around effective date and conversion of income lines.

PREPARED STATEMENT OF DANA L. TRIER

Mr. Chairman and Members of the Committee: I am pleased to have this opportunity to testify concerning the Administration's budget. I would like to begin by reviewing and discussing the specific tax proposals contained in the budget, except for the capital gains proposal, which was the subject of separate testimony before your committee yesterday by Acting Assistant Secretary for Tax Policy Dennis E. Ross. Then I will discuss expiring tax provisions which have not been proposed for extension by the budget.

The budget contains the following proposals affecting receipts: (1) reduction of capital gains rate for individuals; (2) modification and making permanent the research and experimentation credit; (3) modification of research and experimentation expense allocation rules; (4) provision of energy tax incentives; (5) provision of enterprise zone initiatives; (6) provision of child tax credit and making refundable child and dependent care tax credits; (7) permitting deduction for special needs adoption; (8) extension of Medicare insurance coverage to state and local employees; (9) repeal of the airport and airway trust fund tax trigger; (10) extension of the communications excise tax; and (11) certain miscellaneous proposals affecting receipts.

The following provisions will expire in 1989 and are not proposed for extension by the budget: (1) the tax credits for investments in solar, geothermal, and ocean thermal property; (2) the targeted jobs tax credit; (3) authority to issue qualified mortgage bonds and mortgage credit certificates; (4) authority to issue qualified small issue bonds; (5) deduction for health insurance of self-employed; (6) exception to early plan distribution rules for employee stock ownership plans; (7) low-income housing credit; and (8) certain provisions relating to financially troubled thrift institutions. The following provisions expired in 1988 and, we understand, are the subject of sufficient interest to your committee to warrant our comment at this time: (1) exclusion for employer-provided group prepaid legal services; and (2) exclusion for employer-provided education assistance.

SUMMARY OF THE PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS

MODIFICATION AND MAKING PERMANENT THE CREDIT FOR RESEARCH AND EXPERIMENTATION

Current Law

Present law allows a 20 percent tax credit for the increase in a taxpayer's qualified research expenses over a base amount. The base amount is the taxpayer's average annual qualified research expenditures over the prior 3 years. This base, however, is defined so that it can never be less than 50 percent of current qualified expenditures. The credit. is available only for research expenditures paid or incurred in carrying on the trade or business of the taxpayer. As a result, new firms and firms entering a new line of business cannot claim the credit for qualified R&E until the expenses relate to an ongoing trade or business.

The amount of any deduction for research expenditures is reduced by 50 percent of the amount of credit taken for that year. The current research credit expires at the end of 1989.

Budget Proposal

The proposed R&E credit would retain the incremental feature of the present credit and its 20 percent rate, but would make the credit permanent and modify the calculation of the base amount. The new base would be a fixed historical base equal to the average of the firm's qualified R&E expenditures for 1983 through 1987 and would be indexed for inflation. Firms also would have the option of a separate 7 percent credit for expenditures which exceed 75 percent of the base amount. As with current law, all firms would be subject to a base equal to at least 50 percent of R&E expenditures. The proposal also would liberalize the "trade or business" test so that new firms and firms entering new lines of business could claim the credit. Finally, the proposal would reduce the amount of the taxpayer's deduction for research expenses by the amount of the credit.

Discussion

The Administration is committed to encouraging continued growth of private, domestic research activities by establishing a permanent tax credit for research and experimentation (R&E). The tax credit for research is intended to create an incentive for technology innovation. R&E activity, by its nature, is long term and taxpayers should be able to plan their research activity knowing whether the credit will be available. If the credit is to have the intended incentive effect, it should be made permanent.

The proposal also would modify the structure of the current credit to increase its incentive effect and its availability for firms undertaking research. The proposal would increase the credit's incentive effect by replacing the current credit's moving base with a fixed-base structure. The critical feature of this fixed base is that a firm's current spending will have no effect on future credits. Thus, unlike the current credit, a dollar of credit earned in the current year does not reduce credits in future years.

The proposal also would increase the percentage of R&E-performing firms eligible for the credit. This increase is achieved in two ways: (1) through the design of the primary and alternative bases, which results in a larger number of firms with R&E expenditures above the base; and (2) by liberalizing the trade or business test to allow expenditures of new firms and firms entering new lines of business to claim the credit.

Since the proposal would index the credit base, the amount of the credit allowable to any firm and the cost of the credit to the Government would no longer depend on the rate of inflation. Finally, by disallowing a deduction for R&E expenses to the extent of R&E credits taken, the proposal would provide similar tax treatment for all sources of Federal support for research.

Revenue Estimate

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
−0.4	−0.7	−1.0	−1.2

MODIFICATION AND MAKING PERMANENT R&E EXPENSE ALLOCATION RULES

Current Law

Temporary rules for allocating research and experimentation (R&E) expenses generally expired on May 1, 1988. Under those rules, U.S. firms were allowed to allocate 64 percent of their expenses for R&E performed in the United States to U.S. source income. The remaining 36 percent of expenses were allocated between U.S. and foreign source income on the basis of either gross sales or gross income. The amount allocated to foreign source income on the basis of gross income had to be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

Since expiration of the R&E allocation rules, R&E expenses have been allocated between U.S. and foreign source income under detailed 1977 Treasury regulations, which were designed to match R&E expenses with the foreign and domestic source income related to the expenses.

Budget Proposal

The proposal would permit 67 percent of R&E expenses to be allocated to U.S. source income. The remaining 33 percent would be allocated on the basis of either gross sales or gross income. No limitation would be placed on the allocation to U.S. source income under the gross income method.

The proposal would apply retroactively to the expiration of the earlier rules, generally May 1, 1988.

Discussion

The proposal would increase tax incentives for U.S. firms to engage in U.S. based research activity. Current law allocates more R&E expenses to foreign source income and less to U.S. source income than the proposal. The higher allocation to foreign source income under current law reduces the amount of foreign tax credits that firms can use to offset their U.S. tax liability. Because many firms have excess foreign tax credits, the existing allocation regulations can reduce firms' U.S.-based R&E expenditures. Making the rules permanent would provide U.S. firms with the certainty necessary to assess long-term tax ramifications of their R&E expenses.

Revenue Estimate

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
−1.7*	−0.7	−0.8	−0.9

* The FY 1990 revenue loss includes the retroactive application of this proposal.

ENERGY TAX INCENTIVES

Current Law

Current law provides incentives for domestic oil and gas exploration and production by allowing the expensing of certain intangible drilling and development costs ("IDCs") and the use of percentage depletion. Current law does not provide any further incentive for exploratory drilling or tertiary enhanced recovery techniques.

In general, IDCs include expenditures incurred or paid by an operating or working interest owner in the development of oil or gas properties which are neither for the purchase of tangible property or part of the acquisition price of the oil or gas property. IDCs include amounts paid for labor, fuel, repairs, and site preparation. IDCs do not include geological and geophysical costs, nor do IDCs include surface casing costs. IDC deductions on successful oil and gas wells are a tax preference item for purposes of the alternative minimum tax (the "AMT"). Therefore, this tax preference item increases a taxpayer's alternative minimum taxable income, which may subject such taxpayer to liability for the AMT. The IDC preference item for purposes of the AMT is the amount by which a taxpayer's "excess IDCs" claimed with respect to successful wells exceed 65 percent of the taxpayer's net income from oil, gas, or geothermal properties. Excess IDCs" are the amount by which the IDC deduction for the year (attributable to successful wells) exceeds the deduction that would have been claimed had the IDCs been capitalized and either amortized over a 10-year period or recovered through depletion.

Independent producers and royalty owners (but not integrated oil companies) recover capital expenditures with respect to oil and gas properties using the higher of cost or percentage depletion. Under cost depletion, the amount of the depletion deduction is equal to the portion of the taxpayer's basis equal to the percentage of total reserves produced during the year. Under percentage depletion, the amount of the depletion deduction is equal to a statutory percentage of gross income from the property (15 percent in the case of oil and gas production not in excess of 1,000 barrels). The percentage depletion deduction, however, may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction. Unlike cost depletion, percentage depletion may result in deductions over the life of a property in excess of the taxpayer's basis in the property. The percentage depletion deduction may not exceed 65 percent of the taxpayer's net taxable income for the year. The "transfer rule" prohibits percentage depletion with respect to an oil or gas property that is transferred after it has been "proven" (i.e., shown to have oil and gas reserves).

Budget Proposal

The budget contains four provisions intended to strengthen our domestic oil and gas industry. Two proposals would provide temporary tax credits that would be phased out if the average daily U.S. well head price of oil is at or above $21 per barrel for a calendar year. First, a temporary tax credit would be allowed for exploratory intangible drilling costs in the amount of 10 percent of such costs for the first $10 million in expenditures (per year per company) and 5 percent of such costs in excess of $10 million. Second, a temporary 10 percent tax credit would be allowed for all capital expenditures on new tertiary enhanced recovery projects (i.e. projects that represent the initial application of tertiary enhanced recovery to a property). These credits could be applied against both the regular and alternative minimum tax. However, the credits, in conjunction with all other credits and net operating loss carryovers, could not eliminate more than 80 percent of the tentative minimum tax for any year. Unused credits could be carried forward. These credits would be effective for expenditures after December 31, 1989.

The third proposal is to eliminate the so-called "transfer rule" and raise the percentage depletion deduction limitation to 100 percent of the net income from each property. This proposal would be effective for taxable years beginning after December 31, 1989. Finally, the budget proposal would eliminate 80 percent of current AMT preference items generated by exploratory IDCs incurred by independent producers. This proposal would be effective for expenditures after December 31, 1989.

Discussion

The Administration is committed to an energy policy that is designed to strengthen our domestic oil and gas industry and improve the level of domestic energy reserves. The sharp reduction in world oil prices and the increasing levels of oil imports may raise both energy security and national security concerns. The prolonged period of low oil prices has caused a substantial decline in our domestic energy reserves resulting from a 70-percent decrease in domestic exploratory drilling, a 20 percent increase in development drilling, and the abandonment of a large number of marginal wells. The decline in domestic reserves and our increased dependence on foreign oil may leave our nation vulnerable to potential supply disruptions. In addition, our ability to respond to supply disruptions has been impaired to the extent that the prolonged period of low oil prices has damaged our domestic oil industry. The special tax incentives proposed by the budget are appropriate to encourage higher levels of exploratory drilling and the continued operation of our marginal wells. This may lead to increased domestic reserves and a stronger domestic energy industry that would be better able to respond to supply disruptions.

The level of proven domestic reserves is closely related to the level of domestic exploratory drilling. Historically, independent producers have drilled a majority of our exploratory wells even though they are generally much smaller than the integrated producers. The tax incentives on which independent producers have traditionally depended are percentage depletion and the expensing of intangible drilling costs (IDCs). The budget proposals would increase the benefit of these tax incentives and provide additional incentives to encourage exploratory drilling by independent producers.

The budget proposal would also encourage production from marginal properties. The transfer rule discourages the transfer of producing wells from an owner in whose hands the property may be uneconomic to an owner who may be more efficient. The 50 percent of net income limitation may encourage the abandonment of marginal or high-cost properties which produce a relatively small amount of net income. By eliminating the transfer rule and raising the net income from the property limitation to 100 percent, the budget proposal would reduce the likelihood that tax factors will cause the abandonment of producing properties. Finally, by providing a tax credit for tertiary enhanced recovery projects, the budget proposal would encourage the use of such techniques to squeeze additional production from known fields.

Revenue Estimate

[In billions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
10 percent credit for exploratory drilling	−0.2	−0.3	−0.3	−0.4
10 percent credit for tertiary enhanced recovery	(*)	(*)	(*)	(*)
Eliminate the transfer rule and increase the net income allowance to 100 percent for percentage depletion by independent producers and royalty owners	(*)	(*)	(*)	(*)
Eliminate 80 per cent of exploratory IDC tax preferences from minimum tax for independent producers	−0.1	−0.1	−0.1	−0.1

* $50 million or less.

PROVISION OF ENTERPRISE ZONE INCENTIVES

Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in economically distressed areas, they are not limited to use with respect to such areas.

Budget Proposal

The proposed enterprise zone initiative would include selected Federal employment and investment tax credits to be offered in conjunction with Federal, state, and local regulatory relief. Up to 70 zones would be selected between 1990 and 1993.

There would be both capital-based and employment-based tax credits, although the details of the tax credits have not been specified. The extent of the tax subsidies would vary, with larger subsidies in the early years that decline over time. Total Federal revenue losses would gradually rise, however, as more zones are designated.

The willingness of states and localities to "match" Federal incentives would be considered in selecting the special enterprise zones to receive these additional Federal incentives.

Discussion

Despite sustained national prosperity and growth, certain areas have not kept pace. The enterprise zones initiative would stimulate local government and private sector revitalization of economically distressed areas. Enterprise zones would encourage private industry investment and job creation in economically distressed areas by removing regulatory and other barriers inhibiting growth. They would also promote growth through selected tax incentives to reduce the risks and costs of expanding in severely depressed areas.

Revenue Estimates

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
−150	−200	−300	−400

PROVISION OF NEW CHILD CARE TAX CREDIT AND MAKING CURRENT CHILD AND DEPENDENT CARE TAX CREDIT REFUNDABLE

Current Law

The Internal Revenue Code of 1986 (the "Code") provides assistance to low-income working families through both the earned income tax credit (EITC) and the child and dependent care tax credit.

Earned Income Tax Credit. Low-income families with minor dependents may be eligible for a refundable income tax credit of up to 14 percent of the first $6,500 in earned income. The maximum amount of the credit is $910. The credit is reduced by an amount equal to 10 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over $10,240. The credit is not available to taxpayers with AGI or earned income over $19,340. Both the maximum amount of earnings on which the credit may be taken and the income level at which the phaseout region begins are adjusted for inflation (1989 levels are shown). Families have the option of receiving the refund in advance through a payment added to their paychecks.

Child and Dependent Care Credit. Taxpayers may also be eligible for a nonrefundable income tax credit if they incur expenses for the care of certain dependents in order to work. To be eligible for the credit, taxpayers must be married and file a joint return or be a head of household. Two-parent households with only one earner generally do not qualify for the credit.

Employment-related expenses eligible for the credit are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. Further, employment-related expenses cannot exceed the earned income of the taxpayer, if single, or, for married couples, the earned income of the spouse with the lower earnings.

Taxpayers with AGI of $10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with AGI of $10,000 to $28,000, the credit is reduced by 1 percentage point for each $2,000, or fraction thereof, above $10,000. The credit is limited to 20 percent of employment-related dependent care expenses for taxpayers with AGI above $28,000.

Dependent Care Assistance Programs. If the employer has a dependent care assistance program, employees are allowed to exclude from income amounts paid or incurred by the employer for dependent care assistance provided to the employee. The amount excluded from income may not exceed $5,000 per year ($2,500 in the case of a separate return filed by a married individual). An employee generally may not take advantage of both the child and dependent care credit and this income exclusion.

Budget Proposals

Effective January 1, 1990, low-income families containing at least one worker would be entitled to a new refundable tax credit of up to $1,000 for each dependent child under age four. The credit would be equal to 14 percent of earned income, with a maximum credit equal to $1,000 per child. Initially, the credit would be reduced by an amount equal to 20 percent of the excess of AGI or earned income (whichever is greater) over $8,000. In subsequent years, both the starting and endpoints of the phase- out range would be increased by $1,000 increments. In 1994, the credit would phase-out between $15,000 and $20,000. Families would have the option of receiving the refund in advance through a payment added to their paychecks.

The existing child and dependent care tax credit would be made refundable. Families could claim either the new child credit or the child and dependent care credit, whichever would be greater.

Discussion

The proposals would increase the resources available to low-income families, better enabling them to choose the child-care arrangements which best suit their needs and correspond to their personal values.

Revenue Estimate

[In billions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
Revenue loss	(1)	(1)	(1)	.1
Outlays[2]	.2	1.8	2.2	2.4

[1] $50 million or less.

[2] Increased outlays attributable to refunds payable to eligible individuals with no tax liability.

PERMITTING DEDUCTION FOR SPECIAL NEEDS ADOPTIONS

Current Law

Expenses associated with the adoption of children are not deductible under current law. However, expenses associated with the adoption of special needs children are reimbursable under the Federal-State Adoption Assistance Program (Title IV–E of the Social Security Act) under which the Federal Government shares 50 percent of these costs up to a maximum Federal share of $1,000 per child. Special needs children are those who by virtue of special conditions such as age, physical or mental handicap, or combination of circumstances, are difficult to place for adoption. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs.

Budget Proposal

The proposal would permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of $3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. Expenses which were deducted and reimbursed would be included in income in the year in which the reimbursement occurred.

Discussion

The proposal, when combined with the current outlay program, would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents. In addition, the proposal is responsive to the Administration's concern that adoption of these children be specially encouraged and may call to the attention of families interested in adoption the various programs which help families adopting children with special needs.

Revenue Estimate

[In millions of dollars]

Fiscal Years—			
1990	1991	1992	1993
([1])	−3	−3	−3

[1] Less than $500,000

EXTENSION OF MEDICARE HOSPITAL INSURANCE (HI) TO STATE AND LOCAL EMPLOYEES

Current Law

State and local government employees hired on or after April 1, 1986, are covered by Medicare Hospital Insurance and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance nor are they subject to the tax.

Budget Proposal

As of October 1, 1989, all State and local government employees would be covered by Medicare Hospital Insurance.

Discussion

State and local government employees are the only major group of employees not assured Medicare coverage. A quarter of State and local government employees are not covered by voluntary agreements nor by law. However, 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without fully contributing.

Under the proposal, an additional 2 million State and local government employees would be contributing to Medicare. of these, roughly 300,000 employees would become newly eligible to receive Medicare benefits, assuming an employee has satisfied the minimum 40 quarters of covered employment.

Revenue Estimate [1]

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
1.8	1.9	1.9	1.9

[1] Net of income tax offset.

REPEAL OF THE AIRPORT AND AIRWAY TRUST FUND TAX TRIGGER

Current Law

The Airport and Airway Safety and Capacity Expansion Act of 1987 established a trigger that would reduce by 50 percent several of the airport and airway trust fund taxes. The trigger will take effect in calendar year 1990 because the 1988 and 1989 appropriations for the capital programs funded by these taxes were less than 85 percent of authorizations. The trigger will reduce by 50 percent the 8 percent air passenger tax, the 5 percent air freight tax, and the 14 cents per gallon non-commercial aviation fuels tax. It will also substantially reduce the aviation gasoline tax.

Budget Proposal

The proposal would repeal the tax reduction trigger, resulting in increased airport and airway trust fund receipts of $1.2 billion in FY 1990 and increased governmental receipts (net of income and employment tax offsets) of $0.9 billion.

Discussion

Repeal of the trigger is required for the accumulation of funds for the modernization of airport and airway facilities in the United States in the early 1990s.

Revenue Estimate[1]

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
0.9	1.6	1.7	1.8

[1] Net of income tax offsets. The estimates shown are relative to current services receipts which assume continuation of trigger rates through 1994.

EXTENSION OF THE COMMUNICATIONS (TELEPHONE) EXCISE TAX

Current Law

The omnibus Budget Reconciliation Act of 1987 (the "1987 Act") extended the communications excise tax until the end of 1990. The tax is imposed at a rate of 3 percent on local and toll (long-distance) telephone service and on teletypewriter exchange service. Allowing the tax to expire would reduce Federal tax receipts by approximately $2.5 billion annually.

Budget Proposal

The proposal would permanently extend the 3 percent Federal communications excise tax. The tax rate is substantially less than the 10 percent rate that was in effect between 1954 and 1972, and as low or lower than the rate in effect for any year since 1932 (except for 1980–82). The base of the tax would not be broadened.

Discussion

Extension of the communications excise tax would maintain a revenue source that has been in existence continuously since 1932, and would avoid the disruption that would occur if the tax were allowed to expire and then were reenacted.

Revenue Estimate[1]

[In billions of dollars]

Fiscal Years—			
1990	1991	1992	1993
0	1.6	2.6	2.8

[1] Net of income tax offset.

MISCELLANEOUS PROPOSALS AFFECTING RECEIPTS

IRS Enforcement Initiative. The proposal would increase IRS funding for tax law enforcement to improve compliance and collection of past due taxes.

Increase NRC User Fees. The proposal would increase user fees to cover 100 percent of the cost to the Nuclear Regulatory Commission ("NRC") of regulating nuclear power plants costs, effective October 1, 1989.

Initiate FEMA User Fees. The proposal would recover 100 percent of costs of regulating the evacuation plans of the nuclear power industry through user fees, effective October 1, 1989.

Increase D.C. Employer Contribution to CSRS. Under the proposal, the D.C. government would pay retirement cost-of-living adjustments (COLAs) to its retirees and their survivors. The initial annual payment would begin in 1991 because of a proposed budget COLA freeze for government annuitants in 1990.

Extend Reimbursable Status to Amtrak. The proposal would exempt Amtrak from the railroad unemployment tax rate, but would require Amtrak to reimburse the unemployment fund for actual costs of their employees. The proposal would ensure that public subsidies Amtrak receives are used for purposes other than paying for the high unemployment costs of private freight railroads.

Eliminate Superfund Petroleum Tax Differential. The proposal would equalize the superfund petroleum excise tax rates applicable to domestic crude oil and imported products through a slight increase in the tax rate on domestic crude oil and a slight decrease in the rate on imported petroleum products. This would achieve a system of petroleum excise taxes that is consistent with GATT.

Other Proposals. Additional changes affecting receipts include the Administration's pay raise proposals; extension of the customs processing fee, which is scheduled to expire September 30, 1990, at current rates; and the establishment of a fee for the U.S. Travel and Tourism Administration (USTTA). A user fee on taxpayer telephone information services is proposed for 1991; a design evaluation will be conducted in 1989 and 1990 that will include an actual demonstration of the technologies and systems capabilities.

Revenue Estimates

[In billions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
IRS Enforcement Initiative	0.3	0.6	0.7	0.7
Increase NRC User Fees	0.3	0.3	0.3	0.3
Initiate FEMA User Fees	(1)	(1)	(1)	(1)
Increase DC Government CSRS Contributions	0.0	(1)	(1)	(1)
Extend Reimbursable Status to Amtrak	(1)	(1)	(1)	(1)
Eliminate Superfund Petroleum Differential	0.0	0.0	0.0	0.0
Other Proposals	−0.1	0.1	0.1	0.2

[1] $50 million or less.

PROVISIONS THAT WILL EXPIRE IN 1989 AND ARE NOT PROPOSED FOR EXTENSION BY THE BUDGET

BUSINESS ENERGY TAX CREDITS

Background

A tax credit is allowed under section 46 of the Code for investments in certain "energy property." For "solar energy property," the tax credit was 15 percent in 1986, 12 percent in 1987, 10 percent in 1988 and is 10 percent in 1989. For "geothermal property," the tax credit was 15 percent in 1986, 10 percent in 1987 and 1988, and is 10 percent in 1989. For "ocean thermal property," the tax credit was 15 percent in 1986, 1987 and 1988. These credits expire at the end of 1989.

Solar property consists of equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as turbines and generators, that converts the internal heat of the earth into electrical energy or another form of useful energy. Ocean thermal property consists of equipment, such as turbines and generators, that converts ocean thermal energy into electrical energy or another form of useful energy.

The tax credits for solar, geothermal, and ocean thermal property were originally scheduled to expire at the end of 1985, but were extended for three years by the Tax Reform Act of 1986 (the "1986 Act").

Discussion

The tax credits for solar, geothermal, and ocean thermal property were enacted to stimulate the development and business application of these energy sources as alternatives to nonrenewable fossil fuels, such as petroleum, natural gas, and coal. The methods for producing these alternative energy sources were generally well known, but they were not being fully exploited because of price and other advantages of fossil fuel systems. The energy tax credits were intended to increase demand for property producing or using energy from these alternative sources thereby stimulating technological advances in the design, production, and operation of such equipment.

We do not believe that the tax credits for solar, geothermal, and ocean thermal property should be extended. These investment incentives apply only to certain targeted activities. Thus, they produce a tax differential among investments that is inconsistent with the fundamental concepts underlying the 1986 Act. This tax differential distorts the allocation of resources by encouraging businesses to make investments that, without the tax credit, would be uneconomical at current and expected future market prices. We do not believe that this allocative inefficiency can be justified in this case.

Although we oppose extension of the energy tax credits, we recognize the importance of preparing for increased future use of alternative energy sources in light of the Nation's limited reserves of fossil fuels. For this reason, the Federal government provides substantial support for the development of alternative energy sources through energy research and development programs.

The President's fiscal year 1990 budget requests spending authority of $114 million for solar and renewable energy research and development. This research covers a broad range of technologies, with emphasis on the generation of electricity from solar, biomass, geothermal, and wind energy. We believe that these research and development expenditures represent the most appropriate way to promote technological advances with respect to alternative energy sources.

Revenue Estimate

One year extension of business energy credits

[In millions of dollars]

Fiscal Years—			
1990	1991	1992	1993
−56	−35	4	2

TARGETED JOBS TAX CREDIT

Background

Section 51 of the Code allows employers a tax credit for the employment of individuals belonging to one of nine targeted groups. The amount of the allowable targeted jobs tax credit ("TJTC") is generally equal to 40 percent of the first $6,000 of wages paid to a member of a targeted group in the first year of employment. The employer's deduction for wages is reduced by the amount of the credit. A targeted group member must be employed at least 90 days (14 days in the case of summer youth employees) or perform a minimum of 120 hours of work (20 hours in the case of summer youth employees) before an employer qualifies to claim the TJTC. The credit is unavailable for wages paid to an individual who begins work after December 31, 1989.

The nine targeted groups of employees are the following: economically disadvantaged youths (ages 18–22); economically disadvantaged summer youths (ages 16–17); economically disadvantaged youths participating in cooperative education programs; economically disadvantaged Vietnam-era veterans; economically disadvantaged ex-convicts; certain handicapped workers; certain work incentive employees (AFDC recipients and WIN program registrants); supplemental security Income recipients; and general assistance recipients.

For purposes of the TJTC, a worker is economically disadvantaged if the worker's family income is below 70 percent of the Bureau of Labor statistics lower living standard income levels during the prior six months. To claim the credit for an employee, an employer must receive a written certification that the employee is a targeted group member. Certifications of eligibility for employees are generally provided by State employment security agencies. The employer must have received, or filed a written request for, a certification on or before the date a targeted worker begins employment.[1]

Discussion

The TJTC was intended to increase employment of targeted workers who are considered to be low-skilled and difficult to employ and train by reducing the wage costs of employing these workers. The credit achieves its desired effect only when it results in the hiring of targeted employees who would not otherwise have been hired. Where an employer claims the credit with respect to workers who would have been hired without regard to the credit, the credit does not serve its intended incentive effect, and is merely a windfall for the employer.

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[1] If the employer has received a written preliminary determination that the employee is a member of a targeted group, the employer may file a written request for a final certification within five calendar days after the targeted worker begins employment.

The evidence that the credit has not had the intended incentive effect is quite strong. The Labor Department estimated, for example, that in 1981 2.4 million to 3.0 million disadvantaged youths found employment in the private sector of the economy, whereas only 176,000 economically disadvantaged youths received certification for the TJTC. Thus, in that year over 92 percent of economically disadvantaged youths who found employment did so without benefit of the credit.

A net increase in targeted employment may not result even when the TJTC is directly responsible for the employment of a targeted worker. That is, if newly hired certified targeted employees replace previously employed targeted employees who are no longer eligible for the credit or are hired in place of uncertified targeted workers, targeted employment will not increase on a net basis. A recent study of the TJTC by the National Commission for Employment Policy found that many companies retroactively claim the credit, thus receiving a tax windfall for workers hired without regard to their qualification under the TJTC program.[2] Moreover, we believe it is likely that any increase in hiring of targeted workers as a result of the credit is achieved at the expense of other low-skilled workers who have not qualified for the credit but have job skills similar to those of the targeted groups. Finally, increases in targeted employment by firms claiming the credit are partially offset by the loss of employment in other sectors of the private economy.

Other Federal programs currently provide assistance to many of those eligible for the TJTC. Under the Job Training Partnership Act, grants are made to the states to prepare low-income and unskilled youths and adults for entry into the labor force, and contracts are also provided for specialized job training to handicapped persons. The Job-Corps provides remedial training and job skills training for disadvantaged youth. Other training programs are targeted to veterans, native Americans, and migrant and seasonal farm workers.

Revenue Estimate

[In millions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
One Year Extension of the TJTC	−74	−141	−149	−55
Two Year Extension of the TJTC	−74	−196	−295	−210

QUALIFIED MORTGAGE BONDS AND MORTGAGE CREDIT CERTIFICATES

Background

In the 1970s, state and local governments discovered that they could issue tax-exempt mortgage revenue bonds to provide below-market rate mortgage loans to their residents at no cost to themselves. By 1980, the issuance of tax-exempt bonds for owner-occupied housing had grown to 20 percent of total tax-exempt financing. Prior to the Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act"), there were no federal restrictions on who could benefit from the subsidized mortgages financed with these tax exempt bonds. Beginning with the 1980 Act, a series of legislative changes were enacted to target the subsidy to first-time homebuyers, to improve the efficiency of the subsidy, and to curtail the mounting federal revenue losses from the issuance of these bonds.

First, in order to target the subsidy to those individuals with a greater need, the 1980 Act imposed eligibility requirements on mortgages financed with proceeds of qualified mortgage bonds. The 1980 Act required that (a) the mortgages finance only principal residences; (b) the mortgagor not have owned a principal residence during the immediately preceding three years; and (c) the acquisition cost of the residence not exceed 90 percent of the average area purchase price for single family residences. In certain targeted low-income areas, the first-time homebuyer requirement was waived, and the purchase price limitation was increased to 110 percent of the average area purchase price. These requirements were liberalized by the Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Act"). Under the 1982 Act, up to 10 percent of the mortgages in non-targeted areas could be for existing homeowners, and the purchase price limits were increased to 110 percent (120 percent in targeted areas) of the average area purchase price.

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[2] *The Targeted Jobs Tax Credit in Maryland and Missouri: 1982-1987,* National Commission for Employment Policy Research Report No. 88-18 (November, 1988).

The 1986 Act tightened the mortgage eligibility requirements. The 1986 Act reduced to 5 percent the mortgages in non-targeted areas that could be for existing homeowners and reinstated the lower purchase price limits that applied before the 1982 Act. The 1986 Act also imposed a household income limit of 115 percent of the higher of the area or statewide median income. In targeted areas, the income limit was increased to 140 percent of the median and was waived for one-third of the mortgage financing. These income limits were revised by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"). Under the 1988 Act, the income limits are determined by reference to area median income (rather than by reference to the higher of the area or statewide median), the limits are reduced to 100 percent (120 percent in targeted areas) for families with fewer than three persons, and the limits are increased (to no more than 140 percent) in areas where housing costs are high in relation to area median income. The 1988 Act also provides that, in the case of mortgages originated after December 31, 1990, all or a portion of the federal tax subsidy from the mortgage during the first 5 years is to be recaptured through an increase in the mortgagor's individual income tax liability if the assisted home is disposed of within 10 years. The maximum recapture amount (1.25 percent of the mortgage principal amount for each of the first 5 years) is ratably phased out during the second 5 years. The amount recaptured is reduced or eliminated if the mortgagor's income does not increase above a prescribed level and is capped at 50 percent of the gain realized on disposition of the home.

Second, in order to curtail the mounting federal revenue losses from the issuance of mortgage revenue bonds, the 1980 Act imposed a volume cap on the aggregate amount of qualified mortgage bonds that could be issued within a State during a calendar year. The annual volume cap for each State was the greater of $200 million or 9 percent of the average annual amount of mortgages for owner-occupied residences originated in the State during the preceding three years. The 1986 Act repealed the separate volume cap for qualified mortgage bonds and subjected these bonds to the unified volume cap that applies to private activity bonds generally.

Third, in order to ensure that a greater portion of the federal subsidy accrued to the homebuyers, the 1980 Act limited the arbitrage profits that the issuer could earn and retain. The spread between the interest rate on the mortgages and the yield on the bonds was limited to one percentage point. (The allowable spread were increased to one and one-eighth percentage points by the 1982 Act). In addition, any arbitrage profits earned from investing the bond proceeds in non-mortgage investments was required to be paid or credited to the mortgagors (or, if the issuer elected, to the Treasury). The 1988 Act requires the arbitrage profits to be rebated to the Treasury and requires bonds proceeds not used to originate mortgages within 3 years (and mortgage prepayments) to be used to redeem bonds within 6 months.

Finally, in order to provide an opportunity to review the effects of the new requirements, the 1980 Act provided that the qualified mortgage bond program would terminate at the end of 1983. The authority to issue qualified mortgage bonds was extended through 1987 by the 1984 Act, through 1988 by the 1986 Act, and through 1989 by the 1988 Act.

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress tried to improve the efficiency of the mortgage subsidy by allowing State and local governments to elect to trade some or all of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs"). The trade-in rate was set at 20 percent of the nonissued bond amount. MCCs entitle a homebuyer to a nonrefundable income tax credit in the amount of 10 percent to 50 percent (as determined by the issuing authority) of, interest paid on a mortgage incurred to finance the mortgagor's principal residence. The maximum annual credit per recipient is $2,000. Eligibility for the credit is based on the same criteria as for qualified mortgage bonds. The 1986 Act increased the MCC trade-in rate from 20 percent to 25 percent. The authority to issue MCCs is scheduled to terminate at the end of 1989, along with the authority to issue qualified mortgage bonds.

Discussion

The Administration opposes any further extension of the authority to issue qualified mortgage bonds. Other federal support for owner-occupied housing for low- and moderate-income families exists. Moreover, tax-exempt qualified mortgage bonds are very costly and an extremely inefficient means of providing assistance to low- and moderate-income homebuyers.

The federal income tax rules provide substantial assistance to homeowners through the allowance of a deduction for interest on mortgages of up to $1 million incurred to purchase a principal (or second) residence, allowance of a deduction for real estate taxes, rollover of capital gains on sales of a principal residence, and allowance of a one-time exclusion of capital gains of up to $125,000 on the sale of a principal residence by a taxpayer aged 55 or older. As a result, the income from owner-occupied housing investments is exempt from tax over the entire lifetime of most taxpayers. The mortgage interest and real estate tax deductions allow taxpayers to reduce their withholding taxes and have more take-home pay with which to make monthly mortgage payments. We estimate that these special tax provisions provided over $50 billion in assistance to owner-occupied housing in fiscal year 1988.

In addition to preferential tax treatment, other federal programs aid homebuyers. For example, the Federal Housing Administration and veterans' Administration provide mortgage insurance that allows many first-time homebuyers to purchase a home with a low down payment.

Tax-exempt financing is an extremely inefficient means of providing assistance to low- and moderate-income homebuyers. The subsidy is possible because high-income individuals and other persons subject to a high marginal rate of tax are willing to accept lower interest rates on tax-exempt bonds. The portion of the benefits captured by the purchasers of the bonds is large, due to the large outstanding volume of tax-exempt bonds, including mortgage revenue bonds. A GAO study estimates that because of the inherent inefficiency, as well as the significant overhead costs of administering the subsidy, less than half of the tax benefits were passed along to homebuyers.[3] Because of these inefficiencies, the program provides a low rate of subsidy to prospective homebuyers. The program, therefore, is unlikely to encourage home ownership for persons who would not otherwise be purchasing homes. This fact is suggested by the GAO study, which found that two-thirds of assisted households could have afforded the homes they purchased without assistance and that most of the rest could have purchased homes in the near future without assistance.

Finally, the costs of the qualified mortgage bond program are very high. Revenue estimates that focus on the short-term revenue loss resulting from a new tax-exempt bond issue vastly understate the long-term revenue loss. The long-term revenue loss reflects up to 30 years of tax subsidies. For example, we estimate that the revenue loss from all outstanding qualified mortgage bonds in fiscal year 1988 is $1.8 billion, almost all of which is attributable to bonds issued before 1988. In addition, the increased supply of tax-exempt bonds resulting from the qualified mortgage bond program raises interest costs for State and local governments for financing traditional public projects such as schools, roads, sewers, and public buildings.

In summary, extension of the qualified mortgage bond program is unnecessary, inefficient, and very expensive. The qualified mortgage bond program is the least cost-effective means of providing federal assistance to owner-occupied housing and does not provide sufficient assistance to those who may need it to justify its large cost. If Congress deems that additional assistance for first-time homebuyers is necessary, it should consider providing all such assistance in the form of mortgage credit certificates to improve the efficiency of the program.

Revenue Estimate

[In millions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
One-year extension	−37	−44	−41	−35

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[3] U.S. General Accounting Office, *Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need, 1988.*

QUALIFIED SMALL ISSUE BONDS

Background

In the 1960s, State and local governments discovered that they could issue tax-exempt industrial development bonds (IDBs) to provide below-market rate loans to private businesses at no cost to themselves. Prior to the Revenue and Expenditure Control Act of 1968 (the "1968 Act"), there were no federal restrictions on the types of business activities that could benefit from the subsidized loans provided with these tax-exempt bonds. Beginning with the 1968 Act, a series of legislative changes were enacted to restrict the purposes for which tax-exempt IDBs could be issued and to curtail the mounting federal revenue losses from the issuance of these bonds.

The 1968 Act primarily restricted tax-exempt IDB financing to certain exempt activities. The exempt activities for which such financing continued to be available were those that traditionally had been carried on by State and local governments and that furthered some public purpose (e.g., multifamily rental housing, transportation facilities, and sewage and solid waste disposal facilities). The 1968 Act, however, also permitted tax-exempt IDBs to be issued to finance land and depreciable property of any type for any private business as long as the bonds qualified under a special exemption for small IDB issues.

Under the 1968 Act, an IDB qualified as an exempt small issue if the aggregate face amount of the issue did not exceed $1 million. In determining whether the $1 million limit was exceeded, the aggregate face amount of other exempt small issues issued primarily with respect to facilities located in the same locality was taken into account if the principal user of both facilities was the same. The small issue exemption was amended by the Renegotiation Amendments Act of 1968 to permit issuers to elect to apply a $5 million limit in lieu of the $1 million limit. The $5 million limit was applied by also taking into account any capital expenditures incurred during a 6-year period with respect to other facilities in the same locality if the principal user of the bond-financed facilities and the other facilities was the same. The 6-year period began 3 years before and ended 3 years after the date of issue. The $5 million limit was increased to $10 million by the Revenue Act of 1978.

Between 1976 and 1981, tax-exempt IDB financing grew from 33 percent of total tax-exempt financing to 56 percent of total tax-exempt financing. During the same period, annual volume of tax-exempt small issue IDB financing grew from $1.5 billion to $13.3 billion. Based on this growth, annual volume in 1987 was estimated by the Joint Tax Committee to reach $31.3 billion. The proliferation of tax-exempt IDBs was contributing to a significant narrowing of the spread between tax-exempt and taxable interest rates, increased interest costs for State and local governments for financing traditional public projects, distortions in the allocation of scarce capital resources, and mounting federal revenue losses. For these reasons, the 1982 Act eliminated the tax-exemption for small issue IDBs issued after December 31, 1986. The 1982 Act also prohibited use of more than 25 percent of the proceeds of these bonds for certain retail and recreational facilities. Despite the restrictions imposed by the 1982 Act, the volume of tax-exempt IDB financing continued to grow. By 1983, tax-exempt IDB financing amounted to 61 percent of total tax-exempt financing.

The 1984 Act imposed additional restrictions on tax-exempt IDBs. In an effort to curb the continually rising federal revenue losses from the issuance of these bonds, the 1984 Act imposed a cap on the volume of tax-exempt IDBs that could be issued within a State during a calendar year. The annual volume cap for each State was the greater of $200 million or $150 for each State resident. Bonds issued for multifamily rental housing and governmentally owned transportation facilities were exempt from the volume cap. The 1984 Act also restricted the portion of the proceeds of a tax-exempt IDB issue that could be used to acquire land and generally prohibited the acquisition of existing property unless a prescribed level of expenditures was incurred for rehabilitation of the property. Additional restrictions on tax-exempt small issue IDBs were imposed. To eliminate the practice of issuing these bonds to finance each store in a large shopping mall, the $10 million capital expenditure limitation was clarified to apply to an entire project. The 1984 Act also restricted the availability of tax-exempt small issue financing to businesses that benefited from no more than $40 million of outstanding tax-exempt IDBs. The 1984 Act, however, permitted tax-exempt small issue IDBs to be issued to finance manufacturing facilities for two additional years, through December 31, 1988.

The 1986 Act included a comprehensive set of provisions designed to meaningfully constrain the volume of tax-exempt bonds issued by State and local governments to subsidize nongovernmental activities. Between 1975 and 1985, the volume of tax-exempt private activity bonds (including tax-exempt IDBs, student loan bonds, mortgage revenue bonds, and bonds for section 501(c)(3) charitable organizations) increased from $8.9 billion to $124.2 billion. As a share of total state and local borrowing, financing for these private activities increased from 29 percent to 55 percent. The 1986 Act consolidated the two separate state volume caps that applied to IDBs and qualified mortgage bonds into a single unified State volume cap on private activity bonds. The annual volume cap for each State is the greater of $150 million or $50 for each State resident. Bonds exempt from the volume cap are those for airports, docks and wharves, governmentally owned solid waste disposal facilities, and section 501(c)(3) charitable organizations. The 1986 Act repealed authority to issue tax-exempt private activity bonds for several exempt activities that were not traditionally carried on by State and local governments and that primarily furthered private business interests (e.g., bonds for sports facilities, air and water pollution control facilities, and convention and trade show facilities). The 1986 Act also placed restrictions on the exempt activities for which tax-exempt financing continued to be available to target the subsidy to activities that actually served a public purpose (e.g., the low- and moderate-income occupancy requirement for multifamily rental housing projects was significantly tightened). The 1986 Act however, also extended the authority to issue tax-exempt small issue IDBs to finance manufacturing facilities for one additional year, through December 31, 1989. These bonds are now referred to as qualified small issue bonds.

Discussion

The Administration opposes any further extension of the authority to issue qualified small issue bonds for manufacturing facilities. As discussed above, tax-exempt financing is not an efficient or appropriate means of providing a subsidy to private business, and tax-exempt financing should generally be restricted primarily to those activities that traditionally have been carried on by State and local governments and that further public rather than purely private interests.

Moreover, the use of tax-exempt financing to subsidize private manufacturing businesses has anticompetitive and distortive effects on the economy. Manufacturing businesses that receive tax-exempt financing have significant advantages over their competitors, which must raise capital with higher-cost taxable financing. Yet, the availability of qualified small issue financing depends on the size of a particular facility, on the amount of capital expenditures incurred in a particular locality by principal users of the facility, on which localities have the necessary programs in place and the available private activity bond authority to issue the bonds, and on the ability of persons to negotiate through obstacles of State and local law and procedure. It is unrealistic to assume that qualified small issue bond authority will necessarily be allocated to financing of private manufacturing businesses for which any subsidy might actually be necessary or desirable. Furthermore, the use of private activity bond authority to finance these purely private business activities reduces the amount of the subsidy available for the exempt activities that specifically have been targeted and approved for tax-exempt financing.

Revenue Estimate

[In millions of dollars]

	Fiscal Years—			
	1990	1991	1992	1993
One-year extension	−10	−12	−13	−12

DEDUCTION FOR SELF-EMPLOYED INDIVIDUALS OF 25% OF HEALTH INSURANCE COSTS

Section 162(l) of the Code provides that self-employed individuals may deduct 25 percent of the amount paid for health insurance for the individual and the individual's spouse and dependents. In the case of a self-employed individual who has employees, the deduction is available only if the health insurance is provided under a plan that meets the nondiscrimination requirements of section 89. The deduction does not apply to amounts paid in years beginning after 1989.

This provision was added to the Code by the 1986 Act to make more consistent the tax treatment of health insurance benefits provided to self-employed individuals and employees (whose employer-provided health insurance is generally excluded from income), and also to encourage a narrowing of the gap in health coverage among small businesses.

The Administration supports efforts to better coordinate the tax treatment of health insurance expenditures among employees and self-employed individuals and to narrow the gaps in health insurance coverage. However, we believe that an extension of the self-employed health insurance deduction rule does not significantly address the inconsistencies in the tax treatment of health care expenditures and would not result in significant increases in health care coverage. Accordingly, in light of the significant revenue loss that would result from extension, the Administration opposes extension of this provision.

Providing a deduction to self-employed individuals will provide more consistent tax treatment to only small segment of the population. it does not address the more significant inequity between employees whose employer provides health insurance and those whose employer does not. Moreover, the provision will not significantly address the gaps in health insurance coverage. In many cases, the deduction is being utilized by self-employed individuals who would purchase health insurance in any event. In the case of a self-employed individual who has employees, the value of the deduction will in many cases not be sufficient to induce the individual to provide health insurance to the employees. Similarly, the provision provides no benefit to employees who must purchase health insurance on their own.

Revenue Estimate

Permanent extension of the section 162(1) deduction

[In millions of dollars]

Fiscal Years—			
1990	1991	1992	1993
−147	−268	−319	−368

EXCEPTION TO THE EARLY WITHDRAWAL TAX FAR DISTRIBUTIONS FROM EMPLOYEE STOCK OWNERSHIP PLANS

Section 72(t) of the code imposes a 10-percent additional income tax on distributions received by an individual from tax-qualified qualified retirement plans prior to age 59½. Section 72(t)(2)(C) provides an exception from the additional income tax for certain distributions received from Employee Stock Ownership Plans ("ESOPs") prior to 1990.

The Administration opposes extension of the exception from the additional income tax for distributions from ESOPs. The additional income tax on early distributions is designed to discourage individuals from withdrawing their retirement savings prior to age 59½ and to recapture some portion of the tax savings provided to tax-qualified plans providing retirement income. ESOPs receive the same advantage of tax deferral and are subject to the same general distribution rules as other tax-qualified retirement plans, including eligibility for five-year forward income averaging and rollover treatment. The Administration believes that the additional income tax should apply to ESOPs in the same manner that it applies to other tax-qualified plans to discourage employees from diverting their ESOP savings for nonretirement uses.

LOW-INCOME HOUSING CREDIT

Background

A tax credit is allowed under section 42 of the Code for qualified expenditures with respect to low-income residential rental housing. The credit was enacted as part of the 1986 Act, and was intended to provide tax incentives more efficient than those under prior law for encouraging the production of affordable low-income rental housing.

The credit for any low-income building is limited to the amount allocated to the building by a designated State agency, which allocation generally must be made in the year in which the building is placed in service. States may allocate credits each year subject to annual credit authority limitations for each State, may not carry unused credit authority from one year to the next, and may make allocations only through 1989. However, the 1988 Act permits a building to be placed in service within the two years succeeding the year in which the credit allocation is received, provided that (1) the building is part of a project in which the taxpayer's basis at the end of the allocation year is more than ten percent of the reasonably expected basis for the project, and (2) the building involves either new construction or substantial rehabilitation. consequently, while the credit generally is scheduled to expire for property placed in service after December 31, 1989, certain property placed in service by 1991 may qualify for the credit.

The credit is claimed with respect to a qualified building in annual installments during a ten-year period generally beginning with the year in which the building is placed in service. After 1987, the annual tax credit percentage for non-federally subsidized new buildings is determined by the Secretary of the Treasury to yield a discounted present value over the ten-year credit period (based upon federal borrowing rates) equal to 70 percent of the expenditures eligible for the credit. A lesser tax credit percentage, similarly determined by the Secretary of the Treasury to yield a discounted present value equal to 30 percent of eligible expenditures over the ten-year credit period, is available for certain acquisition costs of existing buildings and for federally subsidized new buildings. For these purposes, rehabilitation expenditures are treated as a "separate new building," and "federal subsidies" are defined to include tax-exempt financing and below-market federal loans.

The credit generally is available only for qualifying expenditures with respect to units rented to households satisfying one of two minimum income criteria: (1) at least, 40 percent of the units in a project must be rent restricted and occupied by households having no more than 60 percent of area median gross income; or (2) at least 20 percent of the units in a project must be rent restricted and occupied by households having no more than 50 percent of area median gross income. Gross rents on qualifying low-income units must not exceed 30 percent of the foregoing income limitations.

While the credit is claimed over a ten-year period, buildings must comply with the low-income housing requirements for a period of fifteen years. If, during this compliance period, a building fails to comply with the applicable requirements, or the taxpayer disposes of the building, the taxpayer may have to recapture the credit. Noncompliance or disposition within the first eleven years could result in recapture of one-third of the credit amount, while recapture thereafter would be less.

Discussion

The Administration strongly supports the ultimate objective of the low income housing credit to improve housing for low-income families and individuals. The Administration has not proposed an extension of the low income housing credit as currently structured because the credit does not appear to provide an efficient subsidy for low income housing.

The relative efficiency of the current credit should be fully analyzed before any decision is made to extend the credit. This is especially important as a budget matter because the revenue cost of the low-income housing credit continues for ten years with every year that the credit is extended. Based upon preliminary information for 1987–88, we anticipate that the revenue cost of the low-income housing credit will be approximately $295 million in fiscal year 1989. Moreover, we expect this cost to grow to approximately $715 million in fiscal year 1993 as a result of increased usage of the credit since 1987, placement in service of qualifying buildings through 1991, and continuing claims for credits over the ten-year period following placement in service of a qualifying building.

The motivation for enactment of the low-income housing credit was the inefficiency of the low-income housing tax provisions under prior law. congress was concerned that the tax preferences under prior law were not effective in providing affordable housing for low-income individuals. The preferences under prior law were uncoordinated and not directly related to the number of low-income households being served. In addition, there was no incentive for recipients of tax subsidies to provide more low-income units than the minimum amount required, nor was there any direct incentive to limit rents.

While the low-income housing credit is a clear improvement over prior tax incentives and although the structure of the credit has been significantly improved by recent legislation; we continue to have significant concerns about the efficiency and equity of the credit. Some subsidized units simply may replace units that would have been available in the absence of federal assistance, and the credit may not result in significant long-run housing supply increases. The percentage of the cost of the credit that accrues to the benefit of low-income families is unclear. The additional administrative costs borne by the IRS, HUD, and State agencies as a consequence of the credit have not been determined. The credit includes no requirements for maintenance, and the incentive of landlords renting at below-market rates to prevent deterioration is unclear where there may be no corresponding loss of tenants. Without additional subsidies, project owners may have no economic incentive to continue to rent to low-income tenants after the 15-year compliance period has elapsed. Finally, the credit may not make housing available or affordable to households substantially below the poverty level.

Revenue Estimate

[In millions of dollars]

	Fiscal Years—				
	1990	1991	1992	1993	1990–1993
One Year Extension of Low-Income Housing Credit	−55	−200	−295	−325	−875
Two Year Extension of Low-Income Housing Credit	−55	−260	−505	−635	−1455

SPECIAL TAX RULES APPLICABLE TO REORGANIZATIONS OF FINANCIALLY TROUBLED THRIFTS

Prior Law

In the Economic Recovery Tax Act of 1981 (the "1981 Act"), in order to resolve some of the uncertainties of prior law and to permit the relevant supervisory authority to arrange mergers of financially troubled thrift institutions with healthy institutions at a lower cost to the supervisory authority, congress enacted special tax rules for transactions involving financially troubled thrift institutions.

First, as enacted in 1981, Section 597 provided a special exclusion from income for amounts received by a domestic building and loan association from the FSLIC under its financial assistance program. Section 597 also provides that no reduction in the basis of the recipient's assets is required on account of such a payment. Although Section 597 appears to contemplate that such assistance might be regarded as either a nonshareholder contribution to capital (which would necessitate a basis reduction under Section 362(c)) or gross income, the Treasury Department believes that. in the absence of Section 597, such amounts are generally properly viewed as gross income.

Second, Section 368(a)(3)(D), as enacted in 1981, permitted certain acquisitions of financially troubled thrift institutions to qualify as tax-free reorganizations under Section 368(a)(1)(G), without regard to the continuity of interest or distribution requirements ordinarily applicable in the case of (G) reorganizations. Until December 31, 1988, this rule applied only if (1) the acquired institution was a thrift institution (i.e., a domestic building and loan association, a non-stock cooperative bank organized and operated for mutual purposes and without profit, or a mutual savings bank); (2) the relevant supervisory authority certified that the acquired thrift was insolvent, could not meet its obligations currently, or would be unable to meet its obligations in the immediate future in the absence of action by the supervisory authority; and (3) the acquiring corporation acquired substantially all of the assets and assumed substantially all of the liabilities (including the deposits) of the acquired thrift.

Third, in the case of transactions that qualified under the relaxed rules as a (G) reorganization, section 382(1)(5), as enacted in 1981, permitted the acquiring corporation to succeed to the net operating loss carryovers, built in losses, and excess credit of the acquired thrift, without limitation under Section 382, provided that the shareholders, creditors, and depositors of the acquired institution acquire a 20 percent interest in the acquiring corporation as a result of the acquisition. For this purpose, depositor interests are considered interests in the acquired institution.

In the 1986 Act, congress repealed these provisions effective December 31, 1988.

Current Law

In the 1988 Act, Congress extended these provisions for one additional year, though December 31, 1989, but modified them by requiring that certain tax attributes be reduced by an amount equal to 50 percent of the agency assistance received and by making these provisions applicable to FDIC assisted reorganizations of troubled banks.

Thus, under current law, the provisions of section 368(a)(3)(D) and 382(1)(5) as described above are retained, and extended to banks in the case of transactions that meet certification requirements similar to those required for thrifts. Section 597 as currently in effect excludes both FDIC and FSLIC assistance payments from income, but requires that an amount equal to 50 percent of the amount excludable be applied to reduce tax attributes in the following order: (1) pre-assistance net operating losses; (2) allowable interest deductions; and (3) recognized limit-in losses on certain portfolio assets.

Discussion

The Administration's plan for the S&L industry, as embodied in the proposed "Financial Institutions Reform, Recovery and Enforcement Act of 1989," contemplates permitting these special tax provisions to expire at the end of this year. Although these provisions have played a role in facilitating the resolution of insolvent savings and loan institutions, such indirect subsidies are inherently inefficient and do not permit the kind of full and precise accounting for costs envisioned by the Administration's Plan.

The 1986 Act repeal of these special provisions, after a two year transition period, comported with one of the basic themes of the 1986 Act, that the tax laws should not provide beneficial treatment to some industries, or segments of an industry, and not others. The Treasury Department generally supported this decision as sound tax policy.

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity in May 1985 specifically recommended that these provisions be repealed. That recommendation, however, included a longer transition period, to January 1, 1991. In March 1988, we testified that the Treasury Department remained concerned that the two year transition period provided in the 1986 Act was insufficient, and that we would not object to a one year delay of the repeal of the special provisions. The Treasury Department thus did not oppose the provisions in the 1988 Act that modified and extended these special rules. we are strongly opposed, however, to any further extension of these provisions.

In general, we believe that the subsidization of specific industries through the Federal tax laws is inefficient. In the case of the special provisions applicable to reorganizations of financially troubled thrifts, the subsidy is not only inefficient, but also more costly than congress believed when it acted upon these provisions in 1986 and 1988. As discussed below, the nature of the activity to which these provisions apply makes estimation of the revenue costs extremely difficult.

It is difficult to predict the use and value of the tax benefits provided through the special thrift merger rules. Because these transactions are seldom, if ever, negotiated on the premise that the agency should receive 100 percent of the predicted value of the tax benefits, the use of these rules to provide Federal assistance to FSLIC is inherently inefficient. The acquiring firm may receive a sizable portion of the tax benefits, which means that the cost to the Treasury of providing indirect assistance to FSLIC through the tax code is greater than the: cost of providing direct assistance. Even if the deals were arranged so that FSLIC received 100 percent of the tax benefits, there would be no reason to believe that the acquiring firm would not attempt to "trade" the loss of these benefits and negotiate more advantageous provisions elsewhere in the acquisition contract. For example, an acquiring firm may agree that FSLIC will receive all of the tax benefits, but the firm may demand a lower capital infusion requirement or a higher guaranteed yield on covered assets.

In the revenue estimating process, the uncertainties of predicting the use and value of tax benefits available in an individual transaction are compounded by the lack of knowledge of the tax position of the acquiring firm and the heavy reliance on outlay estimates provided by FSLIC. This is true because the ability of the acquiring firm to use the tax benefits available from a FSLIC assisted merger depends both upon the expected income of the acquiring firm and on the application of the tax rules that restrict the use of the tax benefits, including section 382, section 384, and the separate return limitation year rules of the consolidate return rules to the particular circumstances of that transaction. However, this information is generally not known.

PROVISIONS WHICH EXPIRED IN 1988

EMPLOYER-PROVIDED GROUP PREPAID LEGAL SERVICES

Background

Prior to 1989, the value of employer contributions to, and employee benefits provided under, a "qualified group legal services plan" was excluded from an employee's income under section 120 of the Code. Amounts excluded from income were also excluded from an employee's social security tax wage base. A qualified group legal services plan was defined as a separate written plan of an employer for the exclusive benefit of its employees or their spouses or dependents. The plan was required to provide specified personal (i.e., non-business) legal services to employees through prepayment of, or provision in advance for, all or part of an employee's legal fees for such services. Benefits under the plan were required to be provided in a manner that did not discriminate in favor of officers, owners, or highly compensated employees. In addition, no more than 25 percent of the amounts paid to the qualified plan could be for the benefit of persons holding a more than five percent ownership interest in the employer.

Prior to 1988, section 501(c)(20) of the Code exempted from tax organizations or trusts the exclusive function of which was to form part of a qualified group legal services plan under section 120. These organizations were permitted to provide other legal services or indemnification against legal costs without jeopardizing their tax-exempt status.

With the expiration of section 120, the benefit to an employee' of coverage under an employer-provided legal services plan generally is included in the employee's gross income and social security tax wage base. An offsetting income tax deduction would be allowable to the employee only in very limited circumstances.

Discussion

The Administration would oppose the permanent reinstatement of section 120. This section created inequitable distinctions among taxpayers that, in our view, cannot be justified.

The exclusion for group legal services permitted a limited group of employees to achieve the effect of a deduction for their personal legal costs (and an exclusion of such amounts from the social security wage base), simply because their employers operated qualified group legal services plans. According to a Labor Department study, only 3 percent of all employees had access to such plans in 1985. Thus, although the intent of section 120 was to increase access to legal services for middle income taxpayers, only a small percentage of taxpayers actually benefited. Moreover, section 120 produced an inequitable tax advantage for participants in group legal services plans as compared to the vast majority of other individuals, who, because they could not deduct their personal legal expenses, paid such expenses with after-tax dollars. Even among participants in a qualified group legal services plan, the tax exclusion provided the greatest benefits to higher-income participants who were subject to higher marginal rates of income tax.

EMPLOYER-PROVIDED EDUCATION ASSISTANCE

Background

Under section 127 of the Code, up to $5,250 of the value of educational assistance provided by an employer under a qualified educational assistance program could be excluded from an employee's income. In 1988, such educational assistance did not include expenditures for graduate level courses. Specifically, the exclusion did not apply to any benefits with respect to any course taken by an employee who had a bachelor's degree or was receiving credit toward a more advanced degree, if the particular course could be taken for credit by any individual in a program leading to a law, business, medical, or any other advanced academic or professional degree.

In order to qualify for the exclusion, the educational assistance program was required to meet several conditions, including that the assistance be provided in a manner that did not discriminate in favor of officers, owners, or highly compensated employees. In addition, no more than five percent of the amounts paid under a qualified educational assistance program could be for the benefit of persons holding a more than five percent ownership interest in the employer. Section 127, which was first enacted in 1978, expired on December 31, 1988.

Section 117(d)(2) excludes from taxable income amounts of "qualified tuition reduction," i.e., reduced tuition provided on a nondiscriminatory basis to an employee of an educational organization for the education (below the graduate level) of the employee or the employee's spouse or dependent children. This exclusion is subject to the limitation of section 117(c), which makes the exclusion inapplicable to any amount that represents payment for teaching, research, or other services by the student if the performance of such services is required as a condition for receiving the tuition reduction. Prior to the expiration of section 127, section 127(c)(8) provided that, in the case of a graduate student engaged in teaching or research activities, section 117(d) was applied without regard to the requirement that the education be below the graduate level. The 1988 Act made this provision permanent by adding it to section 117(d). Accordingly, even though section 127 has expired, section 117 serves to exclude from income the portion, if any, of a graduate student tuition reduction that is in excess of reasonable compensation for teaching or research services performed.

With the expiration of section 127, an employer's payment or reimbursement of an employee's educational expenses generally must be included in the employee's income unless the cost of the assistance qualifies under section 117(d) as a tuition reduction, under section 132 as a fringe benefit, or under section 162 as a deductible job-related expense of the employee. In general, educational expenses are treated as job-related only if the education maintains or improves skills required in an employee's retention of his job, job status, or rate of compensation. Education that qualifies the employee for a new job (with the same or a different employer) is not considered job-related.

Discussion

The Administration opposes the reinstatement of section 127 chiefly because this provision accorded tax benefits to only a small proportion of similarly situated taxpayers and did not principally benefit those most in need of educational assistance. This view is supported by a study of section 127 conducted by the Treasury Department, as required by Public Law 98-611. That study was issued in June, 1988.

The tax-favored treatment of educational expenses under section 127 applied to only a small percentage of persons taking courses to train for a new job or occupation, thus creating inequitable distinctions among taxpayers. Obviously, the tax benefit was not available to unemployed persons or to workers whose employers did not offer such programs. Moreover, self-employed individuals and many small business owners were, as a practical matter, unable to benefit effectively from section 127 plans.[4] As Table 1 indicates, 84 percent of all adult education courses taken in 1984 to qualify for a new job or occupation were paid for by the student himself. Thus, only 16 percent of such training could have benefited from section 127.

Moreover, the Treasury Department study and various other studies suggest that the section 127 educational assistance plans failed to achieve the primary objective offered for their tax subsidy, namely increasing opportunities among lower paid, lower skilled workers for training for new, better paying jobs and occupations. Instead, the effect of this tax subsidy may have been to contribute to the sharp increase since 1978 in adult education that is related to the current job and is concentrated among higher paid and better educated workers.[5] Thus, for example, a Labor Department survey found that higher-paid professional and administrative employees were more likely than production workers to have employer educational assistance plans offered to them and were more likely to be offered full, rather than partial, reimbursement.[6] In addition, as Table 2 indicates, less educated workers in lower-paying jobs represented a *smaller* fraction of participants in adult education courses in 1984 than in 1969, before the enactment of section 127.

In summary, although the Administration strongly supports the objective of promoting education, we believe that section 127 unfairly provided, at a substantial revenue cost, preferential treatment to a relatively small group of individuals, a disproportionately high percentage of whom were higher paid professional and administrative personnel. For these reasons, the Administration opposes the reenactment of section 127.

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[4] Although section 127 provided that self-employed individuals and sole proprietors could technically qualify for the benefits of the section, effectively these benefits were primarily available only to employees of larger businesses. closely held businesses were unable to benefit from section 127 because of the requirement that no more than five percent of the amounts paid under the educational assistance program be for the benefit of persons holding a more than five percent ownership interest in the employer.

[5] Department of the Treasury, *Report to the Congress on Certain Employee Benefits Not Subject to Federal Income Tax*, 2 (1988).

[6] U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Medium and Large Firms in 1985*, Washington: U.S. Government Printing Office (1986).

Revenue Estimates

[In millions of dollars]

	Fiscal Years—				
	1989	1990	1991	1992	1993
Three year extension	−70	−430	−319	−97	
One year extension	−70	−215			

This concludes my prepared remarks. I would be pleased to respond to your questions.

EMPLOYER-PROVIDED EDUCATION ASSISTANCE

TABLE 1.—ADULT EDUCATION IN 1984, REASON FOR TAKING COURSE AND SOURCE OF PAYMENT

[In thousands]

	Total courses	Job-related courses				Non-job-related courses	Unknown
		Improve in current job	New job in same occupation	New job in new occupation	other		
Total courses	40,751	19,703	984	3,818	1,654	14,448	145
Employer paid	14,800	12,328	242	549	797	857	28
Row percentages:							
Total courses	100.0	48.0	2.4	9.4	4.0	35.5	0.3
Job-related		75.3	3.8	14.6	6.3		
Employer paid	100.0	83.0	1.6	3.7	5.3	5.8	0.1
Job-related		88.6	1.7	3.9	5.7		
Column percentages:							
Employer paid	36.3	62.6	24.6	14.4	48.2	5.9	19.3

Source: Tabulated from: U.S. Department of Education, Center for Educational Statistics, ***Trends in Adult Education 1969–1984.*** Tables G–H, pp. 33–36.

TABLE 2.—DISTRIBUTION OF ADULT EDUCATION PARTICIPANTS AND THE ADULT POPULATION 17 YEARS AND OLDER BY SELECTED CHARACTERISTICS, MAY 1969 AND 1984

Characteristic	Adult participants		Population 17 years old and over	
	1969	1984	1969	1984
Total number (in thousands)	13,041	23,303	130,251	172,583
Total percent	100%	100%	100%	100%
Sex:				
Men	52	45	47	47
Women	48	55	53	53
Race:				
White	92	92	89	86
Black	7	6	10	11
Other	1	2	1	3
Ethnicity:				
Hispanic	(2)	3	(2)	6
Age group:				
17–34	53	50	37	42
35–54	36	38	35	30
55 and over	11	12	28	28
Education level:				
Less than 12th grade	16	8	44	27
High school graduates	38	30	34	38
Some college (1 to 3 years)	20	26	12	18
Bachelor's degree or higher	26	36	10	17

TABLE 2.—DISTRIBUTION OF ADULT EDUCATION PARTICIPANTS AND THE ADULT POPULATION 17 YEARS AND OLDER BY SELECTED CHARACTERISTICS, MAY 1969 AND 1984—Continued

Characteristic	Adult participants		Population 17 years old and over	
	1969	1984	1969	1984
Regions:				
Northeast	23	17	25	22
North Central	30	26	28	25
South	24	31	31	34
West	23	24	16	20
Income group:				
Above median family income	68	65	50	50
Below median family income	32	35	50	50
Labor force status:				
Employed	78	81	57	61
Unemployed	2	4	3	5
Keeping house, going to school	18	12	27	22
Other (retired, etc.)	3	3	13	13
Occupational groups: [1]				
Executive/managerial	11	15	9	11
Professional/technical	33	31	13	15
Administrative support	17	17	15	16
Sales and service	16	20	27	26
Other	23	17	36	32

[1] The basis of these percentages are employed adult education participants and the employed population 17 years and older.

[2] Not available.

Note: Details may not add to totals because of rounding.

Source: U.S. Department of Education, Center for Educational Statistics, ***Trends in Adult Education 1969–1984***, Table 1, page 3, 1987.

PREPARED STATEMENT OF DR. CHARLS E. WALKER

INTRODUCTION

My name is Charls E. Walker. I am chairman of the American Council for Capital Formation. I appreciate this opportunity to present testimony in support of President Bush's capital gains tax proposal. The American council for Capital Formation hopes that the President's capital gains tax initiative is the beginning of a constructive dialogue on capital gains tax reform.

The history of this debate is not partisan, with support for a capital gains tax differential coming from both Democrats and Republicans. When the issue was last thoroughly debated in 1978, Democratic proponents of a capital gains differential included Senators Lloyd Bentsen, Alan Cranston, and Russell Long, and Congressmen Byrle Anthony, Ed Jenkins, and Jim Jones. Among Republican advocates were Senators Bill Armstrong, Bob Kasten, and Malcolm Wallop and Congressmen Bill Archer, Bill Frenzel, Bill Gradison, and Bill Steiger.

In the current debate, prominent individuals who have spoken out in favor of a reduced tax on long-term capital gains include Michael Blumenthal, Secretary of the Treasury in the Carter Administration, prominent investment bankers Felex Rohatyn and Henry Kaufman, and Nobel prize winner James Tobin, a member of the Council of Economic Advisers during the Kennedy Administration.

The President's capital gains tax initiative differs from traditional capital gains tax cut proposals in that it has been carefully crafted to maximize revenue to the Treasury and investment in the U.S. economy. The proposed maximum tax rate of 15 percent is the result of extensive research in academia and elsewhere on the sensitivity of capital gains realizations to tax rates. One key survey of leading academic and government studies concluded that the revenue maximizing rate is in the range of 9 to 21 percent. The Administration's proposed top tax rate falls in the middle.

This capital gains tax cut would be available to all taxpayers through a 45 percent exclusion. Very significantly, taxpayers with adjusted gross incomes of $20,000 or less would not have to pay a capital gains tax, which is fair since many of them would be paying the tax on purely inflationary gains. Collectibles are excluded and we applaud the Administration's goal of forestalling tax sheltering, although we would suggest alternative mechanisms. There should be a thorough debate on the proposed longer holding period, which is a break with historic levels in the tax code. One should balance the desirability of capital liquidity on the one side with the merits of encouraging long-term investment on the other. We also are unaware of any tax policy reason for excluding corporations from a capital gains tax differential and there are numerous good reasons why they should be included.

We hope to contribute to the current debate by commenting on the economic significance, the fairness, and the revenue consequences of restoring a capital gains tax differential. The thrust of this testimony is that a capital gains tax differential, be it the President's initiative or a Congressional alternative, has important and beneficial economic consequences which should be considered separately from the ongoing debate over the revenue implications of the proposal for the Federal Treasury. The testimony also addresses the revenue raising potential of such a tax change.

Before I begin my testimony, I should say something about the American Council for Capital Formation and our role in the capital gains tax debate. The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to promote jobs, growth and competitiveness. For more than a decade, we have focused much of our attention on the impact of tax policy on saving and investment. In particular, we have been involved in the debates of 1978, 1981, 1986 and 1988 about the appropriate taxation of capital gains.

THE ECONOMIC SIGNIFICANCE

The restoration of a capital gains differential will have economic significance for U.S. saving, the cost of capital, international competitiveness and entrepreneurial effort.

U.S. Saving

Recent testimony before Congress on corporate restructuring and on the problem of the U.S. budget deficit has focused on the problem of our low national saving rate. Reducing the budget deficit will curtail government dissaving but steps to increase private saving are also needed. A discussion of the taxation of capital gains should be looked at in the context of our current tax laws which tend to encourage consumption and discourage saving. Consumption today costs less in terms of foregone future income because income is taxed before it can be saved. Furthermore, any income that flows out of the investment of those savings is also taxed again. If income which is saved—and the further income it generates—were exempt from tax, the cost of current consumption compared to what could be consumed in the future would rise and the incentive to save would be strengthened.

The Tax Reform Act of 1986 substantially increased the bias against saving by imposing one of the largest capital gains tax rate increases since the advent of the capital gains tax differential in 1922. This change took place unfortunately in the context of an increasingly competitive world where most nations tax capital gains more lightly than we did even before the capital gains tax rate increase in the 1986 act. There is a large body of economic research, including that of Harvard Professor Lawrence Summers and Stanford Professor John Shoven, showing that savers do respond positively to higher after-tax rates of return. The capital gains tax increase of the 1986 act reduced after-tax rates of return to investors and therefore made saving considerably less attractive.

THE COST OF CAPITAL

There is a growing concern among economists and policymakers about the cost of capital in the U.S., which is considerably higher in our country than in Japan, West Germany and most of our competitors. Lower capital costs promote higher investment. This increases a nation's capital stock and provides more capital per worker, greater productivity, and growth in a country's standard of living. The capital gains tax is an important element of the cost of capital and the President's initiative should be judged in that context.

Taxes directly influence the cost of capital, which is the pretax return on a new investment required to cover the marginal cost of the investment given the market rate of interest, the rate of inflation, and the taxes levied on the income from the investment. Capital gains tax rates have a significant impact on the cost of capital faced by business because of their impact on the "hurdle rate" which new investment projects are required to meet. Lower capital gains taxes mean that for any given after-tax rate of return required by investors, the pretax return can be smaller and, thus, the cost of capital firms face is lower. As a consequence, more projects will meet the new lower, hurdle rate and investment will be encouraged.

For new endeavors, including venture capital projects, the capital gains tax rate is an especially important component of the cost of capital. For example, Dr. J. Gregory Ballentine, an economist with Peat, Marwick, Main & Co., estimates the cost of capital for investments yielding capital gains increased by 12 percent after the 1986 tax changes relative to an investment yielding ordinary income such as dividends.

Furthermore, research by Dr. Yolanda Henderson, an economist with the Boston Federal Reserve Bank, also shows that the capital gains tax provisions of the Tax Reform Act of 1986 significantly increased overall U.S. capital costs. Dr. Henderson concludes that, had the capital gains tax *not* been raised in 1986, the cost of capital for U.S. business would have risen only half as much as it did. (See Table 1.)

According to simulations based on the Washington University macroeconomic model developed by Laurence H. Meyer & Associates, if the President's proposal were enacted, the overall cost of capital for U.S. firms would decline approximately 11 percent and capital costs for equipment would fall by 14 percent. A decrease of that magnitude would materially reduce the cost of funds to U.S. firms and help narrow the gap between capital costs in the U.S. and abroad.

The cost of capital has been estimated in several studies to be higher in the United States than in several foreign competitor nations. Although some controversy surrounds these data, estimates after the 1986 Tax Reform Act suggest that the cost of capital in the United States has been about 50–75 percent greater than the cost of capital in Japan. In a paper prepared for the American Council for Capital Formation Center for Policy Research, Dr. John Shoven, chairman of Stanford University's Economics Department, found that after the 1986 tax act, the cost of capital in the U.S. was 63 percent higher than in Japan, 26 percent higher than in Germany, and 81 percent higher than in the United Kingdom. The 1989 *Economic Report of the President*, prepared by the Council of Economic Advisers (CEA) notes the tax burden on corporate equity capital in the U.S. is much higher than many of our competitors. Higher capital gains taxes exacerbate this spread and further reduce saving and investment incentives.

The linkage between the cost of capital, which is influenced by tax policy, and a country's standard of living is described in a 1988 article by Harvard Professor Lawrence Summers, Thermo Electron Chairman George Hatsopolous, and MIT economist Paul Krugman. The authors explain that the cost of capital is much lower in Japan with the result that investment in plant and equipment in that country is twice as high as in the U.S. This helps explain the higher productivity in Japan and the faster growth in the Japanese standard of living.

For these and other reasons, business economists overwhelmingly support a reduction in capital gains tax rates. According to a survey of the National Association of Business Economists released February 27, 1989, by a margin of 79 percent to 21 percent, the economists said the President's capital gains tax proposal will improve capital formation.

INTERNATIONAL COMPARISONS OF CAPITAL GAINS TAXATION

The U.S. taxation of capital gains should also be analyzed in the context of the treatment afforded capital gains by our international competitors. They recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation. An Arthur Andersen & Co. study comparing tax rates on corporate stock found that U.S. capital gains taxes are among the highest in the world. (See Table 2.) Germany, Japan, and South Korea, among others, exempt long-term capital gains on portfolio stock from tax or tax gains only lightly. As Dr. Shoven's research makes clear, the favorable treatment of capital gains in Germany and Japan is an important element in their lower capital costs.

ENTREPRENEURIAL EFFORT

Restoring a capital gains tax differential will have a particularly powerful impact on the entrepreneurial sector of the American economy, making possible new technological breakthroughs, new startup companies, and new jobs. Venture capital is a process requiring a number of participants: entrepreneurs, informal investors, venture capital funds, and finally, healthy public markets. All of these participants are sensitive to after-tax rates of return. The key to successful venture investment is the ability to attract and motivate the entrepreneur. By taxing the entrepreneur's potential gain at a higher rate, either the pool of qualified entrepreneurs will be reduced or the investors will have to accept a lower rate of return. In either case, the implications for the American economy are clearly negative.

Furthermore, fledgling companies depend heavily on equity financing from family, friends, and other informal sources. Professors William E. Wetzel and John

Freear of the University of New Hampshire surveyed 284 new companies and found that private individuals were the major source of funds for new companies raising $500,000 or less at a time. The individuals providing startup capital for these new companies do pay capital gains taxes and are sensitive to an increased tax rate on gains.

It is true that a portion of the organized venture capital pool comes from tax exempt entities but the informal pool is equally important. Data collected by the National Venture Capital Association documents the fact that private taxable investors, including corporate venture capital funds, provide on an informal basis as much funding as does the organized venture capital industry. Most importantly, it is the taxable investors who, more often than not, provide the seed corn for the new firms, with tax exempt pension funds and formal venture capital pools entering the funding process at a later stage. The willingness of tax exempt entities to participate in the venture capital process is also dependent, to a very large extent, on a vibrant stock market which is directly affected by the level of capital gains taxes.

The Tax Reform Act of 1986 discouraged entrepreneurial endeavors. An analysis prepared by Dr. Ballentine of Peat, Marwick, Main & Co. concludes that the 1986 act fails to recognize that many capital gains investments are inherently risky and that realized capital gains often include purely inflationary gains that are not income. In fact, the combined effect of taxing inflationary gains and limiting the deductibility of capital losses leads to severe over taxation and produces a "surtax" on many investments that will earn capital gains.

For example, assuming a 4 percent real return and 5 percent inflation, a taxpayer in the 28 percent marginal tax bracket pays a 29 percent higher tax on an asset yielding capital gains held for 5 years than on one which earns ordinary income, such as dividends, and which is taxed currently. Even worse, under the same assumptions, a taxpayer in the 28 percent bracket who realizes a gain on a "high risk" capital asset faces a tax rate 50 percent higher than the rate on ordinary income on an asset held five years. (See Chart 1.) Higher taxes on risky capital assets result from the fact that, while capital gains are subject to full taxation, losses are allowed only limited deductibility. These factors clearly discourage investment.

Conversely, the earlier 1978 and 1981 capital gains tax cuts proved to be an economic success story. These cuts improved the investment climate, facilitated a record number of new stock offerings, bolstered corporate equity values, and resulted in employment gains across the entire spectrum of the economy.

THE FAIRNESS ISSUE

There is much controversy about the "fairness" of capital gains tax cuts. There are two aspects to the fairness issue. What is most often discussed is the predicted distribution of taxes paid by different income classes. What, in fact, is more important is the beneficial impact to the U.S. economy and the fairness of opportunities created or lost for the less fortunate in our society which has already been discussed in this paper.

First, a threshold question is whether saving should be taxed at all. Many Americans, in fact, believe that saving should be exempt from taxes.

Second, many Americans do not believe capital gains should be taxed or, if taxed, should be taxed lightly. For example, a November 1988 survey by the Media General/Associated Press found a plurality of poll respondents supported a reduction in federal capital gains taxes. A decade ago, in 1978, when the now well-known Steiger capital gains initiative was hotly debated in Congress and around the country, surveys of public attitudes on capital gains taxes showed strong support for substantial cuts in gains tax rates. One such survey (Louis Harris, "The Harris Survey," August 14, 1978) asked for a reaction to this statement: "In order to get the economy going again, it is important to provide incentives for people to want to invest their money through measures such as a capital gains tax reduction." An overwhelming 70-19 percent majority agreed with this proposition.

Third, contrary to what opponents of lower capital gains tax rates suggest, the American middle class, not the very wealthy, are hit hardest by the capital gains tax hikes of the Tax Reform Act of 1986. Under the 1986 act, taxpayers with incomes under $30,000 will generally see a tripling of capital gains tax rates; that is much more than the 75 percent tax hike for taxpayers earning more than $200,000. If one looks at combined Federal and state capital gains taxes before and after the 1986 act, the tax increase for the middle class is even more dramatic. According to a 1987 Arthur Andersen & Co. study, for a middle income Arkansan, the combined capital gains tax increases by 84 percent; for a similarly situated Oregonian and Virginian by 118 percent; and for a middle income New Yorker by 149 percent. The

President's initiative corrects some of this inequity by exempting families with less than $20,000 in adjusted gross income from the tax.

Fourth, taxpayers with moderate incomes are responsible for a substantial amount of reported capital gains. In 1984 and 1985, taxpayers with incomes of $50,000 or less reported 23 percent of all long-term capital gains. Although their share of long term gains fell to 15 percent in 1986 because of the increase in upper income realizations, gains reported by taxpayers with incomes of $50,000 and below surged 43 percent in that year, to a record $45 billion.

Fifth, Jodie Allen, a columnist for the Washington Post, best described the fairness of current law in a recent article. (January 11, 1989). Compare, she wrote, the "fairness" of taxing a family of modest means that takes a capital gain on a long-held asset and pays a 33 percent tax on a perceived gain which may be a capital loss due to inflation with a speculator who pays only a 28 percent tax on a multi-million dollar short-term profit.

Sixth, logic, historical experience, and academic research indicate that lower capital gains tax rates coincide with higher government revenues from upper income taxpayers.

Consider the logic. The capital gains tax is a voluntary tax. Taxpayers alone can decide when and if to realize their capital gains. This is especially true of upper income taxpayers with large, unrealized capital gains. Many commentators make the classic error of assuming the tax rate on unrealized gains for the wealthy is 28 or 33 percent when it is in fact zero. To the extent that a lower capital gains tax encourages the realization of gains that would otherwise not be triggered, the effective tax rate on that particular income rises from zero to 15 percent rather than declining from 28 percent to 15 percent.

Now, consider the historical experience. In the period 1978–85, when capital gains taxes were reduced from 50 percent to 20 percent, total individual capital gains tax receipts increased from $8.5 billion to $23.7 billion. The bulk of this new revenue for Uncle Sam came from upper income taxpayers. Total capital gains realizations by those with annual incomes over $100,000 increased almost 700 percent between 1978 and 1985 compared to a 120 percent increase for those with incomes below $100,000.

Finally, consider recent academic research. In a 1987 analysis of a 15 percent capital gains tax, Dr. Lawrence Lindsey, formerly a Harvard professor and currently an economic adviser to President Bush, found that 70 percent of the new revenue to the Treasury from the "unlocking" of gains will come from taxpayers with incomes over $100,000 and 40 percent from those with incomes greater than $200,000.

In short, it is important to remember that the tax yield on unrealized, locked in capital gains is precisely zero. It is wrong to describe a capital gains tax rate reduction as a "tax break for the wealthy" when in fact the taxes paid by this sector will multiply dramatically.

REVENUE IMPLICATIONS

In this time of severe budgetary pressures, one should take very seriously the revenue implications to the U.S. Treasury of any spending or tax initiative. There has been extensive research in academia and government on the revenue consequences of higher and lower capital gains tax rates. The findings are inconclusive but the research provides much support for a capital gains tax cut as a revenue raiser.

Before examining those findings, it is helpful to review the new Treasury and Joint Committee on Taxation's analyses of President Bush's capital gains initiative. The Treasury estimates the President's proposal will increase Federal revenues substantially in FY 1989–93 due to a large part to greater induced realizations. There will be a one-time loss in FY 1994–96 caused only by the phase-in of a new three year holding period. In the years 1997 and beyond, the Treasury Department forecasts increased tax receipts of $1–$2 billion annually. The Joint Committee on Taxation estimates the President's proposal will result in initial revenue gains in FY 89–90, but lead to significant losses in subsequent years. (See Tables 3 and 4 for a comparison.)

What we can all agree upon is that the revenue dispute is not a minor one. It is in the range of $30–40 billion over a four-year budget period. In the period 1989–93, for example, the Treasury estimates the President's proposal is a $16 billion gain; the Joint Committee estimate is a $13 billion loss. This is probably the first time there has been such a serious disagreement on revenue estimates between the Treasury Department and the Joint Committee, suggesting the immediate need to reconcile these differences and to pinpoint the underlying factors which create them.

In our judgment, the Treasury estimate of the impact of the President's capital gains tax proposal fits better with logic and historical experience.

The logic is simple and intuitive. Economists of all persuasions—Keynesians, conservatives, supply-siders, and liberals—agree on one point. Since capital gains taxes are voluntary, higher capital gains tax rates do not necessarily result in greater revenues to the government because taxpayers may choose not to realize their gains if the tax penalty is too high. The critical question policymakers should ask is: What is the revenue-maximizing capital gains tax rate? This question should be put before the Treasury and the Joint Committee on Taxation.

The historical experience is compelling. The very recent historical experiment (1978–86), when the maximum capital gains tax was cut from 50 to 20 percent, did not result in lower capital gains tax receipts. To the contrary, tax revenues from capital gains were 179 percent higher in 1985 than in 1978. Inflation and stock market fluctuations, alone, are not sufficient to explain this phenomenon. Rather, the behavioral response of taxpayers and the economy to a lower capital gains tax simply proved to be substantially greater than anticipated by official government revenue estimates.

What it basically comes down to is a judgment about the level of behavioral response and the permanency of that effect. Another recent real world example to look at are the estimates of the impact of the 1986 tax act's tax hikes on capital gains tax receipts in fiscal year 1987 (calendar year 1986). All analysts agreed there would be some unlocking of accrued gains in 1986 in anticipation of the substantially higher capital gains tax rates in 1987 and beyond. The Joint Committee on Taxation anticipated more than an $8 billion revenue pickup in FY 1987. The actual receipts were in the range of $20–22 billion. Some assert that this was just a one-time effect, but we suggest that the historical evidence resulting from the 1978 and 1981 capital gains tax cuts shows that the revenue impact of lower capital gains tax rates is permanent rather than transitory.

CONCLUSION

In conclusion, the debate about the appropriate taxation of capital gains has been with us almost since the inception of the Federal income tax. From 1922 until 1986, a capital gains tax differential existed as part of U.S. tax policy for very sound economic policy reasons which are recognized by almost all of our economic competitors. A capital gains tax cut will be productive for the American economy and fair for American taxpayers. Although there is considerable controversy about the revenue consequences of the President's capital gains initiative, a very strong and credible case can be made that this initiative, with its very important economic consequences, will not reduce revenues.

Enclosure

Table 1: Impact of Tax Reform Act of 1986 and Capital Gains Tax Increases on the Cost of Capital to the Coporate Sector

Cost of Capital
(Percent)

Prior Law	Tax Reform Act	% Change from Prior Law	Tax Reform Act of 1986 w/ pre-1986 Ind. Capital Gains Rate	% Change from Prior Law
6.5	7.5	15.4	7.0	7.7

Source: "Investment Allocation and Growth under the Reform Act of 1986" by Don Fullerton and James Mackie in Compendium of Tax Research, 1977; OTA Department of the Treasury, Washington, D.C., 1987; and unpublished data by Yolanda Henderson. The analysis incorporates the "new view" of dividend taxation which holds that the taxation of dividends does not provide a serious disincentive to marginal investment in the corporate sector.

Table 2: Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investments in 1989

COUNTRIES	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
INDUSTRIALIZED				
United States (A)	33.0%	33.0%	One Year	None
Australia	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (B)	17.51%	17.51%	None	None
France (C)	16%	16%	None	None
Germany (D)	56%	Exempt	Six Months	0.5%
Italy	Exempt	Exempt	None	None
Japan (E)	5%	5%	None	None
Netherlands	Exempt	Exempt	None	0.8%
Sweden	45%	18%	Two Years	0.3%
United Kingdom (F)	40%	40%	None	None
PACIFIC BASIN				
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

*State, provincial and local taxes not included.

(A) The nominal tax rate for long- and short-term capital gains is 28 percent. The marginal rate, however, rises to 33 percent for joint returns between $74,850 and $155,370 and for single returns between $44,900 and $93,130 for calendar year 1989.

(B) Canadian residents are allowed an annual capital gains exemption of Canadian $ 30,000 ($22,998**) subject to a cumulative exemption of up to Canadian $500,000 ($383,300**) in 1990.

(C) Gains from proceeds of up to FF 272,000 ($45,288**) are exempt from taxation in a given taxable year.

(D) The first DM 1,000 ($554**) of short-term capital gains is exempt from tax.

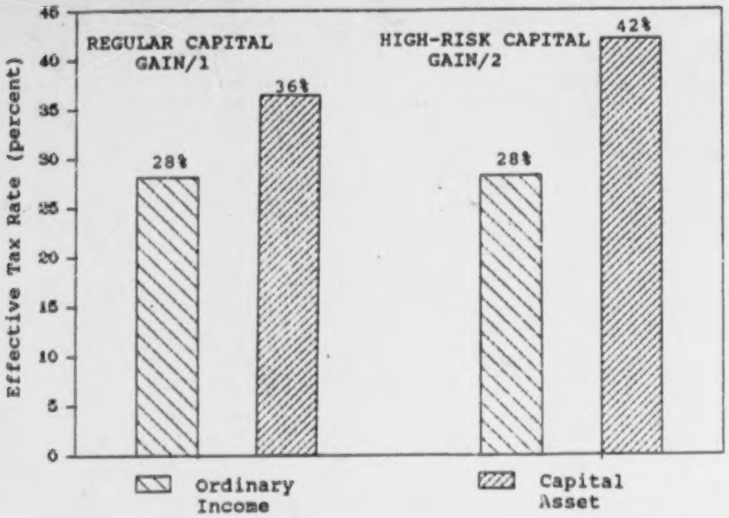
(E) Japan's tax reform plan, which takes effect in 1989, imposes a maximum tax of approximately 5 percent on the sale of securities.

(F) Only gains and losses accrued since 1982 will be taxed; gains since 1982 are indexed.

** Based on exchange rates as of March 31, 1987.

Source: Prepared by Arthur Andersen & Co., for the Securities Association in March, 1987; updated by the American Council for Capital Formation Center for Policy Research, March, 1989.

Chart 1.
Effective Tax Rate & Surtax on Regular & High-Risk Capital Gains, Compared to the Tax on Current Income



Note: The examples compare an investment earning current income (5% real return with 4% inflation) with capital assets yielding the same after-tax return and held for a five-year period before realization. The surtax on a capital asset (8% for a regular asset and 14% for a high-risk asset) results from the taxation of inflationary gains and the limitation on the deductibility of capital losses.
1 Taxpayer in 28% bracket faces a 29% surtax on the capital gain. Calculated as follows: 36%-28%=8%; 8%/28%=29%
2 Taxpayer in 28% bracket faces a 50% surtax on the capital gain. Calculated as follows: 42%-28%=14%; 14%/28%=50%

Source: J. Gregory Ballentine. "The Tax Penalty on Capital Gains." August 1987.

Table 3: Revenue Impact of President Bush's Capital Gains Tax Proposal, 1989-1999

Treasury Estimate

Fiscal Years ($ billions)

	Budget Period						Longer Run*					
Effects of Proposal	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	1989-94
Effect of Tax Rate Reduction on Existing Gains Projected For Current Law Realizations	-1.6	-11.9	-17.6	-19.1	-20.2	-21.0	-21.5	-22.0	-22.5	-23.0	-23.5	
Effect of Increased Realizations	2.4	17.1	21.8	21.8	21.5	22.3	22.3	22.9	23.4	23.9	24.5	
Effect of Delaying Gains Until the Effective Date	-0.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Effect of Conversion of Ordinary Income to Capital Gains Income	0.0	-0.1	-0.6	-1.3	-1.9	-2.5	-2.5	-2.6	-2.6	-2.7	-2.8	
Effect of Excluding Depreciable Assets and Collectibles	0.2	1.2	1.7	1.9	2.1	2.1	2.3	2.4	2.4	2.5	2.5	
Effect of Phased-In Three Year Holding Period	0.0	0.0	0.0	0.4	1.0	-7.4	-2.3	-11.7	-0.1	1.5	1.5	
Effect of 100% Exclusion for Certain Low-Income Taxpayers	-0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	
TOTAL REVENUE EFFECTS OF PROPOSAL	0.7	4.8	4.9	3.5	2.2	-6.8	-2.0	-11.3	0.2	1.8	1.8	9.3

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Notes: These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.
Details may not add up due to rounding.
Disaggregateed effects are stacked in sequence.
*Longer run estimates assume 1994 growth extends past the budget forecast period.

Table 4: Revenue Impact of President Bush's Capital Gains Tax Proposal, 1989-1994

Joint Committee on Taxation Estimates

	Fiscal Years ($ billions)						
Item	1989	1990	1991	1992	1993	1994	1989-94
1. 45% Exclusion	0.3	0.6	-6.2	-8.9	-9.8	-11.6	
2. Effective Date	0.3	1.8	0.0	0.0	0.0	0.0	
3. Exclusion of Certain Asset Types	0.2	1.3	2.7	2.9	3.1	3.2	
4. 3-Year Holding Period	0.0	0.0	0.0	0.1	0.3	-1.9	
5. Exclusion for Certain Taxpayers	-0.1	-0.4	-0.4	-0.5	-0.5	-0.5	
TOTAL REVENUE EFFECT	0.7	3.3	-4.0	-6.4	-6.9	-10.9	-24.2

Joint Committee on Taxation   February 23,1989

COMMENTS ON DEPARTMENT OF TREASURY AND CONGRESSIONAL JOINT COMMITTEE ON TAXATION ANALYSES OF CAPITAL GAINS REVENUE AND DISTRIBUTIONAL ISSUES

BY

DR. MARGO THORNING, CHIEF ECONOMIST, AMERICAN COUNCIL FOR CAPITAL FORMATION

I. Introduction

This paper addresses some of the revenue and distributional aspects involved in changing the current law treatment of capital gains. A careful review of available evidence suggests that the Administration's proposal may indeed raise revenue and make the tax system more progressive.

II. Capital Gains Tax Rates and Revenues

A. HISTORICAL EXPERIENCE

1. The 1978 and 1981 Tax Reductions

Research by the U.S. Department of the Treasury concludes that the combined effect of the 1978 and 1981 capital gains tax cuts was to increase Treasury revenues.[1] The study reestimated the time-series equation presented in the 1985 Treasury report, first using the original 1954–1982 sample data base and then using data revisions published subsequently.[2] Then the regression sample was extended through 1985, adding three years of data that were not available when the original report was written. A major finding of the Treasury study is that extending the regression sample through 1985 sharply increases the estimated revenue gains from the 1978 act. In particular, the Treasury study found that the assertion of Joseph Minarik, that "by 1980, the revenue gain from the 1978 law had essentially evaporated" [3] is only true when the incomplete sample is used. The Treasury study also revealed that the extended sample and the superior method used for adjusting nominal GNP for inflation yield much less severe revenue losses from the Economic Recovery Tax Act of 1981 (ERTA) than do the regressions based on 1954–82 only. When both adjustments are made, Treasury estimates that the combined effect of the two laws was a direct revenue increase of $4.7 billion over the 1979–1985 period.

Treasury Assistant Secretary Michael Darby, Robert Gillingham and John S. Greenlees (DGG) defended the Treasury analysis of the effects of the 1978 and 1981 capital gains tax cuts from criticism by Dr. Minarik in a piece in *Tax Notes.*[4] In the article, they note that they agree with Minarik on three points: that both time-series and cross-section analyses have strengths and weaknesses; that the two analytical approaches have complementary roles; and that their results ideally should agree. They state that the purpose of the Treasury research was, in fact, to show that a correct interpretation of the time-series evidence brings it into closer agreement with the cross-section evidence. Because the elasticity (or measure of behavioral response) is generally greater for cross section studies than for time series, estimates are based on cross section data which tends to be more optimistic about the revenue impact of a capital gains tax cut than those based on time series data. DGG comment that Minarik is disingenuous in criticizing them for putting one type of analysis "at the bottom of a two-element totem pole". Minarik has previously characterized the Treasury's time-series results as "much more meaningful" than cross-sectional predictions, and in his comment on DGG's paper, he makes a similar argument.

Minarik repeatedly has warned researchers to avoid relying on cross-section evidence without being "able to find the revenues in the time-series data after the capital gains tax cut takes place." The Treasury Office of Economic Policy staff turn that comment around, stating

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[1] "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time-Series Evidence", Treasury Bulletin, U.S. Department of the Treasury, Office of the Secretary, Spring Issue, June 1988.

[2] "Report to Congress on the Capital Gains Tax Reduction of 1978" Office of the Secretary of the Treasury, September 1985 and "How Capital Gains Rates Offset Revenues: The Historical Evidence," Congressional Budget Office, March 1988.

[3] Joseph Minarik, "Raising Federal Revenues Through a Reduction in the Capital Gains Tax," statement before the Ad Hoc Committee on the Taxation of Capital Gains, February 2, 1988.

[4] Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Black Box Revealed: Reply to Minarik." Tax Notes, July 25, 1988.

> If you continue to believe that the time-series evidence proves that tax cuts will lose money, if you think that the revenue-maximizing capital gains tax rate is 35 or 40 percent, you are going to have to explain why constant-dollar Federal capital gains revenues more than doubled between 1978 and 1985, while the marginal tax rate fell by around 40 percent. As we emphasized in our paper, our time-series explanation of this phenomenon is not definitive, but it is certainly informative.

2. Feldstein Analysis of the Effect of the 1978 Tax Cuts on Realizations

The Joint Committee on Taxation (JCT) testimony of March 14, 1989 before the Senate Finance Committee attempts to discount academic studies such as that by Feldstein, Slemrod and Yitzhaki, which predicted an immediate tripling in realizations as a result of the 1978 act.[5] The JCT testimony fails to note that- the Feldstein study focused on the responsiveness of high- income taxpayers in realizing capital gains on corporate stock. As Feldstein et al. point out in their "reply" to Minarik, the actual data seem to support this contention.[6] Data on long-term realizations compiled by the ACCF Center for Policy Research in fact support the Feldstein analysis. As shown in Table 1, the realized long-term gain of taxpayers in the $500,000 and over Adjusted Gross Income (AGI) class more than tripled from 1978 to 1979, rising from $3.7 billion to $13.0 billion. Realizations continued to rise, and by 1982 had increased sixfold for the over $500,000 class. Indeed, for taxpayers in the $100,000 and above AGI class, realizations had almost tripled by 1981, and by 1982 they had more than tripled. Thus, the JTC's attempt to discredit the Feldstein analysis is open to serious criticism.

III. THE ADMINISTRATION PROPOSAL: REVENUE EFFECTS

A. THE PROPOSAL

The Administration's proposal would establish a maximum capital gains tax rate of 15 percent for individuals; it would not apply to corporations. The proposal would provide a 45 percent exclusion for gains on qualified assets; taxpayers with $20,000 or less in AGI (joint returns) would be eligible for a 100 percent exclusion. The proposal would require a holding period of 12 months or more for qualified assets sold in 1989, 1990, and 1992; 24 months for assets sold in 1993 and 1994; and 36 months for assets sold in 1995 and thereafter. The proposal would define capital assets as under current law, but collectibles and depreciable or depletable property would be excluded.

B. RATIONALE FOR SCORING THE PROPOSAL AS A REVENUE RAISER

In his recent testimony before the Senate Finance Committee, Treasury Acting Assistant Secretary Dennis E. Ross defended the revenue-enhancing capabilities of the Administration proposal (see Table 2). Ross testified that the effect of the static rate cut (line 1) would be more than offset by increased realizations (line 2). These induced gains are either accelerated from realizations in future years, are due to portfolio shifting to capital gain assets from fully taxable income sources, or taxable realizations that otherwise would have been tax-exempt because they would have been held until death, donated to charities, or realized but not reported.

In Treasury's view, its assumption regarding taxpayer responsiveness (elasticity) to the rate changes is comfortably in the middle of the range reported in the studies.[7] Treasury estimates an elasticity of 1.2 in the short run, dropping to about 1.0 in the long run, and to about 0.9 after considering the impact of converting ordinary income but before targeting the proposal for certain kinds of assets. Ross observes that estimates made by the staff of the Joint Committee on Taxation employ a much lower long-run estimate—perhaps as low as 0.7—which is within the range of the studies, but in Treasury's view clearly at the lower end. This difference in elasticities, which may seem relatively small, accounts for the great bulk of the difference between the Treasury and the Joint Committee on Taxation estimates, Ross states.

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[5] Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains", Quarterly Journal of Economics, vol. 94, June 1980 and "Reply to Minarik", Quarterly Journal of Economics, Vol. 99, February 1984.

[6] Joseph J. Minarik, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Comment." Quarterly Journal of Economics, Vol. 99, Feb. 1984.

[7] The level of taxpayer responsiveness is generally termed "elasticity," which in this context is shorthand for the expression "percentage increase in induced capital gains divided by the percentage decrease in the overall capital gains tax rate." Thus, a tax cut will tend to generate a revenue increase if the elasticity is estimated to be greater than 1, no change in revenue if the elasticity is exactly 1, and a revenue loss if the elasticity is less than 1.

Ross also notes that even an elasticity response of slightly less than 1 will still generate a revenue increase, because taxpayers paying the highest tax rates are the most responsive to a capital gains tax decrease. Induced realizations are disproportionately distributed, with more being taxed at above-average tax rates and fewer being taxed at below-average rates. hat is at issue is the elasticity of revenues with respect to rate changes, not realizations.

The Ross statement is supported by the 1988 Treasury study (mentioned in part II) In their analysis of the capital gains rate cuts of 1978 and 1981, DGG found average and marginal rates do not always move proportionately and that it is the average tax rate which influences revenues. They state that "there are a number of economic explanations for these mathematical results. First, the tax cuts analyzed did not reduce the marginal tax rate by the same proportion for each taxpayer. Second, even for a given taxpayer, average and marginal tax rates did not have to change proportionately, because of movements along the rate schedule. Finally, cross-sectional evidence reveals that capital gains realizations are generally much more elastic at high than low rates. This relationship implies that a proportionate reduction in marginal tax rates will increase the share of gains taxed at the highest rates, so the average tax rate falls less than proportionately." [8]

C. DOUBLING OF REALIZATIONS

Treasury expects the amount of realizations induced under the Administration proposal to almost double (see Table 3). Defending this estimate, Ross notes that this near doubling of realizations, from an estimated $183 billion to about $349 billion at 1989 levels, may seem remarkably optimistic until it is placed in the following perspective.

—The total accumulation of unrealized qualifying gains at the end of 1987 was an estimated $4 trillion.

—If we exclude from this figure gains on personal residences, which largely escape tax because of the rollover and one-time $125,000 exclusion, the total pool of gains that could be realized is still $2 trillion.

—The year-over-year increase in this accumulation—a good guide to the potential long-run realizations—has been running about $350 billion per year, even with personal residences excluded, and is expected to grow.

In light of historical experience, and of the large pool of unrealized gains, JTC's contention that a doubling of gains is unlikely does not seem convincing. Furthermore, realizations may not need to double if high income taxpayers' response to the Administration proposal is stronger than that of low income taxpayers because the gains of high income taxpayers would be taxed at 15 percent while those of low income taxpayers would be taxed at rates as low as 8.3 percent.

D. JTC'S ESTIMATES OF ALTERNATIVE CAPITAL GAINS CUT PROPOSALS

In an April 4, 1989 revenue estimate, the JTC noted that a flat 25 percent tax rate on *all* assets (including depreciable property) would lead to a negligible revenue loss over five years. Subsequent conversations with JTC staff suggest that the Administration's proposal, imposed at a rate higher than 15 percent, could indeed be a revenue raiser.

IV. The Administration Proposal: Distributional Aspects

In addition to enhancing revenues, the Treasury analysis suggests that the Administration proposal will increase the amount of capital gains taxes paid by higher income classes (see Table 4). For example, taxpayers with income in excess of $50,000 would pay 86.0 percent of capital gains taxes in 1991 under the Administration proposal compared to only 84.5 percent under current law.

The JTC also presents data on the distributional impact of the Administration proposal. Their analysis, which is based on the percentage distribution of the tax burden rather than on tax paid (as Treasury shows), indicates that upper income taxpayers receive most of the "benefit" of lower rates (Table 5) Taxes paid by different income classes seems to be as good a measure, if not better, of the distributional aspect of capital gains taxation as does a more ephemeral concept of tax burden.

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[8] *Treasury Bulletin, op. cit.*

V. Conclusion

This paper has reviewed the evidence on whether previous capital gains tax cuts increased tax revenues and finds that the evidence supports this conclusion. Examination of the Treasury and JCT on the Administration proposal suggests that the revenue maximizing rate is lower than current law.

Enclosure

Table 1: Realized Net Long Term Capital Gain
Less Long-Term Loss, for Selected Years,
($ in millions)

Adjusted Gross Income Class (AGI)	1978	1979	1981	1982	1983	1984	1985	1986/p	Percentage Change (1978-1986)
Under $25,000	$9,731	$13,512	$13,219	$10,210	$14,104	$17,740	$17,365	$20,344	109.1
$25,000-50,000	9,026	12,189	10,214	8,468	14,582	11,681	13,834	24,315	169.4
$50,000-100,000	6,608	9,467	11,227	10,189	16,692	19,496	24,402	41,286	524.8
Sub-Total	25,365	35,168	34,660	28,867	45,378	48,917	55,601	85,945	238.8
$100,000-500,000	8,607	15,582	18,984	21,338	29,801	33,197	45,393	85,682	895.5
Over $500,000	3,692	13,101	14,965	24,486	30,754	40,557	50,426	137,640	3628.1
Sub-Total	12,299	28,683	33,949	45,824	60,555	73,754	95,819	223,322	1715.8
Grand Total	$37,664	$63,851	$68,609	$74,691	$105,933	$122,671	$151,420	$309,267	721.1

p/preliminary
Source: Statistics of Income, Individual Income Tax Returns, Internal Revenue Service, various issues. Prepared by ACCF Center for Policy Research, May 1988.

Table 2

Revenue Effects of The President's Capital Gains Proposal
Fiscal Years 1989–1999

Effects of Proposal	Fiscal Years ($billions)										
	Budget Period						Longer Run*				
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Effect of Tax Rate Reduction on Existing Gains Projected For Current Law Realizations	-1.6	-11.9	-17.6	-19.1	-20.2	-21.0	-21.5	-22.0	-22.5	-23.0	-23.5
Effect of Increased Realizations	2.4	17.1	21.8	21.8	21.5	22.3	22.3	22.9	23.4	23.9	24.5
Effect of Delaying Gains Until the Effective Date	-0.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effect of Conversion of Ordinary Income to Capital Gain Income	0.0	-0.1	-0.6	-1.3	-1.9	-2.5	-2.5	-2.6	-2.6	-2.7	-2.8
Effect of Excluding Depreciable Assets and Collectibles	0.2	1.2	1.7	1.9	2.1	2.1	2.3	2.4	2.4	2.5	2.6
Effect of Phased In Three Year Holding Period	0.0	0.0	0.0	0.4	1.0	-7.4	-2.3	-11.7	-0.1	1.5	1.5
Effect of 100% Exclusion for Certain Low Income Taxpayers	-0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
TOTAL REVENUE EFFECT OF PROPOSAL	0.7	4.8	4.9	3.5	2.2	-6.8	-2.0	-11.3	0.2	1.8	1.8

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Notes:

These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.
Details may not add due to rounding.
Disaggregated effects are stacked in sequence.
** Longer run estimates assume 1994 growth extends past the budget forecast period.*

Table 3

Realizations of Net Long Term Capital Gains Under Current Law and an Across the Board Rate Cut 1/

($ Billions)

Tax Year	Realizations Under Current Law	Realizations Under Rate Cut 1/	Change in Realizations Rate Cut 1/
1980	71	--	--
1981	78	--	--
1982	87	--	--
1983	117	--	--
1984	136	--	--
1985	166	--	--
1986	319	--	--
1987 P	140	--	--
1988 E	135	--	--
1989 E	151	288	137
1990 E	168	333	165
1991 E	183	349	167
1992 E	193	357	164
1993 E	201	367	166
1994 E	206	384	178
1995 E	210	393	183
1996 E	215	402	187
1997 E	220	412	192
1998 E	225	421	196
1999 E	230	431	201

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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

'P'. Data are preliminary and include short term capital gains.
'E'. Estimate.

Table 4

Distribution of Net Capital Gains, and Tax Liability Under Current Law and an Across the Board Rate Cut 1/

(Calendar Year 1991, $Billions)

Adjusted Gross Income Class Under Current Law	Capital Gain Realizations		Tax on Capital Gains	
	Current Law	Rate Cut 1/	Current Law	Rate Cut 1/
Less Than $10,000	19	22	0.9	0.7
$10,000 to $19,999	7	10	0.9	0.7
$20,000 to $29,999	8	12	1.3	1.2
$30,000 to $49,999	15	29	3.3	3.6
$50,000 to $99,999	24	54	6.3	7.5
$100,000 to $199,999	23	50	6.4	6.9
$200,000 or more	86	172	22.2	23.7
TOTAL	182	349	41.3	44.3

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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

Table 5—Distributional Effect of the President's Capital Gains Proposal,[1] 1990 Income Levels

Income class[2]	Number of returns with tax change (thousands)	Aggregate tax change (millions of dollars)	Average tax reduction (dollars)	Percent distribution of aggregate tax change
Less than $10,000	72	−15	202	0.1
$10,000 to $20,000	695	−177	255	0.9
$20,000 to $30,000	1,216	−286	235	1.5
$30,000 to $40,000	1,498	−498	332	2.6
$40,000 to $50,000	1,083	−682	630	3.5
$50,000 to $75,000	1,581	−1,270	803	6.6
$75,000 to $100,000	539	−1,011	1,876	5.2
$100,000 to $200,000	875	−3,808	4,351	19.7
$200,000 and over	376	−11,603	30,820	60.0
Totals	7,935	−19,350	2,438	100.0

[1] This calculation assumes that qualified assets are held in the same proportions across income classes as are all assets.

[2] The income concept used to place tax returns into income classes is adjusted gross income plus (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside build-up on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences, from passive business activities.

Source: Joint Committee on Taxation Staff.

COMMUNICATIONS

STATEMENT OF ZOLTAN KISS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHRONAR CORP., PRINCETON, NJ

On behalf of the Chronar Corporation and the photovoltaic industry, I urge the U.S. Congress to extend the Solar Business Energy Tax Credit at the current 10 per cent level for a minimum of three years through December 31, 1991.

While the photovoltaic industry has made tremendous strides in achieving cost competitiveness with traditional energy resources and systems, it has done so against the greatest of odds. It is not unreasonable to state that the photovoltaic technology has been brought to market in spite of U.S. government policies. In 1980, the U.S. Department of Energy budget for photovoltaic research and development reached its highest point of $60.1 million. Each year since then, the Administration in power has acted to cut the funding significantly. Presently, this most important technology program is funded at $35 million. This very week, the Industry is working to prevent further cuts proposed by the Bush Administration from being adopted by the House Appropriations Committee.

In addition to the cuts in federal funding for research and development, the federal and state tax incentives for the commercialization of solar energy systems have all but disappeared. The remaining federal incentive is the Solar Business Tax Credit. It was given a one-year extension by the 100th Congress. It expires on December 31 of this year, only 9 months from now. While the extension may facilitate some sales this year, the lack of a solid, long-term commitment to a research, development and commercialization path is most detrimental to this Industry. Just watch Wall Street. Mere rumors of a change in fiscal policy by the Administration sends investors scurrying.

Short-term, piecemeal extensions at the eleventh hour are particularly harmful to Chronar and other solar companies that are trying to commercialize technologies for large-scale commercial, industrial, and most importantly, grid-connected utility system applications. Chronar has a real-world example. Last year Chronar secured an option to install a small photovoltaic power station in Southern California. This was the Company's first opportunity to install a commercial-scale, grid-connected power station. It was a very important development not only for Chronar, but the entire photovoltaic industry. It was of significant size to establish credibility and to verify reliability and costs to the utility industry. The total cost of the project was $15 million. The uncertainty over the extension of the Solar Business Tax Credit became a key factor in the negotiations with investors because it enhanced the otherwise marginal internal rate of return. Financing for the project disappeared as the clock ticked past the 100th Congress.

The uncertainty created by the lack of commitment to a sound tax policy to support the commercialization of photovoltaic technologies combined with continued efforts to cut federal funding for research and development is particularly damaging given that the Industry has been in existence for less than 15 years.

These uncertainties affect the Industry on several fronts:

(1) *Research and Development.* The U.S. Industry's ultimate success is, of course, directly related to its ability to stay on the cutting edge through continued research and development. While the U.S. has cut federal solar research and development funding by 80 per cent since 1981, Germany, Japan and other industrialized nations have increased consistently their funding commitments to the development of the photovoltaic technology.

(2) *Financing.* Chronar's objective is to be the largest and lowest-cost producer of photovoltaic panels and systems. To achieve the development and growth of a company infrastructure that operates efficiently and effectively, it is essential to have investors with deep pockets and a 5 to 7-year view toward return on investment.

The lack of a comprehensive National Energy Policy, adequate photovoltaic research and development funding, and commercialization incentives, especially given the full government support our Japanese and German competitors receive, make it particularly difficult to attract and maintain the support of institutional investors.

(3) *Competitiveness.* Chronar views the integration of photovoltaic panels and systems into the design and construction of large-scale residential, commercial; and industrial buildings as a major market that has not been tapped. This year, construction will start in California on the world's largest photovoltaic panel manufacturing facility. The lower cost and increased power efficiency of the panels that it will produce, will enable Chronar to enter these markets with products such as curtain wall and skylighting systems. Unlike consumer products, which are often emotionally-based purchases, these products will be scrutinized closely by architects, engineers and accountants to determine their cost-benefit in comparison to traditional products.

Another untapped market of great potential to Chronar is the electric utility industry. Today, Chronar is the only U.S. photovoltaic company in a position to sign a contract for the delivery of a photovoltaic power station of 10 MgW or greater annual electrical output.

In an ideal world, Chronar would compete without any government assistance on an even playing field with the fossil and nuclear fuel industries. But, given the enormous subsidies provided to these industries, the only way to provide equity in today's market place is to also subsidize the photovoltaic technology.

While the continuation of the 10 per cent Solar Business Tax Credit will hardly offset the cumulative benefit of the massive subsidies received by the fossil and nuclear industries, it will help open the door to certain electric utility market areas.

The photovoltaic industry is at a crucial point in its development. This technology can, with adequate support, play a major role in providing electrical power worldwide.

Chronar and its financial partners—the Sheet Metal Workers' National Pension Fund, the International Brotherhood of Electrical Workers' National Pension Fund, Pacifica Gas and Electric Enterprises, Bechtel Development Company, and Harbert Capital Services—are doing their part to accelerate the pace at which photovoltaic systems are available at competitive market prices. It certainly behooves this Nations' government to join private industry and labor in accomplishing this objective.

Any reasonable means that aide the photovoltaic Industry in gaining experience and credibility with new markets, especially the electric utility industry, is vital.

The small revenue loss that will occur from a 3-year extension of the Solar Business Tax Credit will be minuscule compared to losses this Nation will incur if this technology is lost to our competitors.

I urge you to extend for a minimum of 3 years the Solar Business Tax Credit. Thank you.

STATEMENT OF ESOP ASSOCIATION

Mr. Chairman, and Members of the Senate Committee on Finance: The ESOP Association, a national and international membership organization of nearly 1500, urges the Committee and Congress to make permanent the Internal Revenue Code Section 72(t)(2)(C), which is currently scheduled to expire at the end of this year.

Code Section 72(t)(2)(C) provides that an individual's receipt of a distribution from an employee stock ownership plan (ESOP) is not subject to the 10% additional tax on early distributions from a qualified deferred compensation plan.

The reason for the special ESOP exception to the 10% early withdrawal tax is as valid today as it was in 1986, when the Senate Finance Committee adopted the exception as part of its ESOP package included in the Tax Reform Act of 1988 (TRA 86).

To understand the reason for the Committee's action, it is necessary to refer to the House provisions on ESOPs included in TRA 86.

In the fall of 1985 the House Ways and Means Committee adopted a package of ESOP "reform" amendments. These amendments, offered en bloc by House member Beryl Anthony, included an amendment mandating that an ESOP distribute a participant's account upon the participant's termination from employment, even if the participant was under age 55. (I.R.C. Section 409(o)). This House amendment thus made the ESOP different from other qualified ERISA plans, which may keep the terminated participant's account until he or she reaches retirement age.

The genius of this House amendment was to make the ESOP account more visibly tied to the employee's work effort, and to blunt the criticism of ESOPs as not providing current income similar to a person with direct stock ownership. (These ESOP critics claimed real ownership meant the owner could "sell" or "cash-in" his or her stock whenever they wished.)

Congressman Anthony did not wish to have ESOP participant's cash-out their accounts whenever they wished, but he did want to prevent employers from locking-up the participant's accounts for years after termination.

Furthermore, the Congressman felt that once an employee left the employee-owned company, he or she no longer had input in the productivity or economic health of the former employer. He felt to leave the former employee/ESOP participant's assets in the securities of a former employer eliminated the link between employee-ownership and possible productivity benefits.

When this House provision was reviewed by the Senate Finance Committee, Senator Russell Long, then ranking minority member, decided it was not fair on the one hand to mandate the ESOP sponsor to make early distribution while on the other hand punishing the individual recipient of that distribution with a special 10% penalty tax. He, therefore, included a version of Section 72(t)(2)(C) in the Senate version of TRA 86. (The full Senate, on a roll call vote, unanimously voted for all provisions of the Finance Committee's ESOP provisions.)

In August 1986, the House-Senate conference adopted the Senate version with a 3-year sunset.

Over the past 3 years, nothing has occurred that diminishes the fairness of the ESOP exception.

To allow Section 72(t)(2)(C) to expire would serve no purpose except to hurt the individual receiving an ESOP distribution.

We are certainly aware of the Administration's position that Section 72(t)(2)(C) should expire and that the recipient should rollover his or her ESOP distribution into an IRA. We are also aware that extending Section 72(t)(2)(C) would reduce Federal revenues by a modest $10 million in Fiscal Year 1990, and $21 million in Fiscal Year 1991.

We, again, in retort to the Administration's position emphasize that TRA 86 mandates early distributions from ESOPs, unlike other qualified deferred compensation plans. Thus, it is not fair to eliminate this exception to the general rule on the 10% tax, which arose because of the ESOP distribution exception to the general rule on distributions.

The Committee's consideration of the Association's members' position is appreciated.

STATEMENT OF GEOTHERMAL RESOURCES ASSOCIATION

Mr. Chairman and Members of the Committee, on behalf of the members of the Geothermal Resources Association (GRA), our firm, Van Ness, Feldman, Sutcliffe & Curtis, welcomes the opportunity to submit comments for the hearing record. Our purpose is to urge the Committee to extend the energy tax credits for qualifying geothermal property beyond the scheduled December 31, 1989 expiration date.

The GRA is the association of major U.S. geothermal producers and developers who are actively developing geothermal resources on our Nation's public and private lands. Member companies of the GRA include small, independent geothermal developers, and large, integrated energy producers. I would be pleased to provide, for the record, a list of our membership.

Currently, under Section 46 of the Internal Revenue Code, a 10 percent nonrefundable energy tax credit is allowed for certain investments in geothermal property provided that a project is placed in service prior to December 31, 1989. The credit was originally enacted in an effort to encourage commercial development and use of alternative energy technologies. Although we are currently not experiencing conditions similar to the energy crises of the mid and late 1970's, there is still a need to maintain a commitment to alternative energy resources if this country is to achieve independence from foreign and unstable sources of petroleum.

It is important to underscore that our dependence on imported energy continues to grow as prices remain low and supplies are abundant. The use of imported energy, which supplied 21.3 percent of U.S. energy use in 1988, is expected to grow at a very rapid annual rate of 4.0 percent between 1988 and the end of this century. Imported energy will provide almost 30 percent of the total energy used in the United States in 2000. Net petroleum imports are expected to increase from an average 6.3 million barrels per day to 10.2 2 million barrels per day by 2000. This would account for 55 percent of all petroleum used in the U.S. in 2000 and 24.3 percent of total energy used in that year. (Source: *1989 Annual Energy Outlook, Long Term*

Projections, Energy Information Administration, Department of Energy, January 1989.) The DOE's 1987 report to the President on Energy Security reported that by 1995, the volatile Middle East producers and OPEC will control as much as 60 percent of the world market for oil. At that rate, by 1995 the United States might be spending $80 billion a year on oil. This is $52 billion above the $28 billion we spent on imported oil in 1986. That out-flow of U.S. dollars is a principal reason we are hemorrhaging in our trade balance. Furthermore, our own domestic sources of oil and gas, despite the rosy predictions, shrink smaller and smaller. A recent U.S. Geological Survey (USGS) review of its estimates of American oil and gas reserves concluded that we have 11 years of undiscovered oil left at today's rates of production and 14 years of natural gas.

Geothermal energy should be examined in this context of growing dependence on foreign sources and diminishing supplies of domestic fossil fuels. According to the USGS, U.S. geothermal resources could potentially provide 95,000 to 150,000 megawatts of electrical generating capacity. To date, approximately 2,300 megawatts of geothermal powered capacity has been constructed in the United States. Depending on the cost of competing fuels it is quite possible that by the mid-1990's the geothermal industry might be responsible for generating more than 3,000 megawatts of electricity from an abundant and environmentally benign fuel source.

Even though the development of geothermal energy continues at a robust pace, thanks in large measure to the assistance of the energy tax credit, it is clear that tax incentives are still required to bring this nascent industry to maturity. High technological risks, whether real or perceived, low competing fuel prices (albeit temporary) and the high capital requirements needed to construct a geothermal power plant (even though fuel costs—geothermal—are low) have combined to make continued development of this important resource questionable once existing power purchase contracts are consummated.

The Administration recently testified that the energy tax credits should be allowed to expire. Support for geothermal resources is confined to the research and development effort administered by the Department of Energy. Unfortunately, simply providing funds for long range geothermal research and development does not address the concerns of today's developers who have projects that will be completed within the next two years. We believe the short and long-term potential of geothermal energy will be best assured if this Committee continues support—through an extension of the energy tax credit—of existing developers and the projects they are currently pursuing. In the case of many projects, the business energy tax credits have been the difference between a viable project and one that cannot proceed forward. While we do not wish to discourage research and development activities, we merely point out that R&D funding does not replace the financial incentives to current commercial development provided through the energy tax credit.

The tax credits are particularly important as the only tax incentive remaining after the elimination, over the past couple of years, of state tax benefits and the regular investment tax credit. The energy tax credit has provided that slight hedge to developers that can make the difference when they decide whether or not to take the extra risk in building a power plant that utilizes geothermal resources or before entering into a power purchase contract. It can also make the difference, particularly in the case of small developers, in whether or not they can assemble the necessary financing for a project. All of these factors emphasize the importance of the business energy tax credits.

One final, but important comment. There are a dwindling, but significant number of companies with projects that are approaching completion, that have been relying, over the years of the projects' planning, permitting, and construction, on the existence of the energy tax credits. For those projects especially, the continuance of the energy tax credit is critical to the economic survival of the project and in some instances the developer. Thus, an extension of the credit, or an assurance that the credit will be available for those projects, is vitally important.

Thank you for the opportunity to submit the views of the Geothermal Resources Association on the expiration of the business energy tax credits for qualifying geothermal property.

STATEMENT OF ICICLE SEAFOODS, INC.

Icicle Seafoods, Inc. of Seattle, Washington submits this statement to the International Trade Subcommittee of the U.S. Senate Committee on Finance for inclusion in the record of the hearing on "U.S.-Canada Trade Disputes" scheduled for April 7, 1989.

Icicle Seafoods, Inc., on its own behalf and on behalf of nine other seafood processing companies located in Washington State and Alaska, filed a Section 301 Petition with the Office of the U.S. Trade Representative on April 1, 1986. The gravamen of the petition was the assertion that Canadian law forbade the export of unprocessed salmon and herring to the United States in violation of General Agreement on Tariffs and Trade (GATT) and is therefore an unfair trade practice under Section 301 of the Trade Act of 1974. The Canadian export restriction gives Canada's fish processing companies a competitive advantage because they are able to freely purchase unprocessed salmon and herring in the United States when additional supplies are needed. U.S. fish processing companies are denied this ability by the Canadian export restriction.

A summary of the history of this dispute is as follows:

1986

April 1—Section 301 Petition filed with USTR.
May 16—USTR initiated investigation and requested consultations with Canada.
September 3 and October 27—Consultations between U.S. and Canada.

1987

February 20—US requested GATT to establish a dispute settlement panel.
June—GATT panel was designated and met with U.S. and Canada on June 18 and July 10.
November 4—GATT panel ruled in favor of the U.S., finding Canada's export restrictions in violation of GATT Article XXXIII.
March 11—Consultations between U.S. and Canada.
March 22—Canada says it will accept GATT panel decision and remove export prohibition by January 1, 1989. Certain Canadian officials announce intent to substitute landing restriction for export prohibition to protect Canadian industry. Landing of all fish in Canada prior to export was indicated.
March 23—GATT panel report is adopted by GATT Council.
August 30—USTR publishes a Notice of Proposed Determination and Action under Section 301. The Notice requests comments on the impact of Canada's export restrictions and alternative Canadian landing or inspection requirements.
September—Canadian negotiators in Free Trade Agreement (FTA) talks attempt to include provision "grandfathering" Canadian provincial laws that prevent the export of unprocessed fish. U.S. negotiators object but agree to language referring to export prohibition laws of the maritime provinces on the East Coast (i.e. not British Columbia), and making the language subject to GATT. Article 1203 of the FTA.

Congress amends FTA implementing legislation to require the President to take appropriate action within 30 days of any action by Canada applying export restrictions referred to under Section 1203 of the FTA or applying landing requirements.

January 1—Canada does not remove its export prohibition on herring and salmon.
January 4-5—Canada begins consultations with USTR and discloses, for the first time, landing law program for West Coast salmon and herring only. USTR offers counter proposal to allow landing in U.S. subject to Canada's regulations.
February 2—Canadian negotiators reject counter proposal by the U.S.

Recently, Ambassador Carla Hills met with Canadian Trade Minister John Crosbie and indicated that Canada's proposed landing requirements were not acceptable to the United States because of the delay inherent in landing the fish and resulting reduction in the fish's value. *See, 6 International Trade Reporter* 323 (March 15, 1989).

This dispute has continued without a satisfactory resolution for almost three years. During this time, the petitioners have had to endure the fact that Canadian fish processing companies are able to freely purchase unprocessed fish in the United States to increase their inventories, while U.S. fish processors are denied this ability by Canadian law. Canada has not fulfilled its promise to GATT to remove its export prohibitions on salmon and herring, and the Canadian herring season is now nearly over for 1989. Canadian government foot-dragging has been an obvious negotiation tactic, requiring our government to press for a resolution at every turn only to see more delay from Canada each time. Our fish processing companies are increasingly dismayed by the strong "free trade" rhetoric coming from the two governments while resolution of this dispute remains as uncertain as when the case was filed in 1986. Moreover, USTR has been unwilling to support reciprocal measures that would eliminate the obvious buying advantage of Canadian companies in U.S. fish markets.

On March 28, Ambassador Hills determined that Canada's failure to lift the export restriction denies the United States rights to which it is entitled under a trade agreement and has published a notice of possible retaliation. *See*, attached Federal Register notice. A hearing has also been scheduled for April 26, 1989 to consider a final list of products that would be subject to increased duties or other trade restrictions if Canada does not comply with the GATT ruling.

Retaliation is not welcomed by the Petitioners in this case. Unfortunately, the Canadian government is unprepared to deal with this dispute on a straight-forward basis and to eliminate the export restrictions and not replace them with equally restrictive landing requirements. The dispute has been fairly and effectively handled by the Office of the U.S. Trade Representative, without threats or rhetoric. But this approach has been met with continual resistance and delay from the Canadian negotiators. From this, our negotiators have concluded that only the toughest measures, i.e. retaliation against Canadian fish exports, will get that country to reach a meaningful settlement.

In conclusion, the Petitioners want an early and quick resolution of this dispute that fulfills the "free" trade promise of the Free Trade Agreement between the United States and Canada. Many of the Petitioners have now become victims of the worst oil spill in U.S. history and will suffer substantial and loss of business as a result. Access to fish in Canada will help soften the blow to our fish processing operations. We hope the Subcommittee will continue to monitor this dispute and to press for a resolution as soon as possible.

Enclosure

For the Nuclear Regulatory Commission.

James R. Hall,

Acting Director, Project Directorate III-3, Division of Reactor Projects - III, IV, V and Special Projects, Office of Nuclear Reactor Regulation.

[FR Doc. 89-7523 Filed 3-30-89; 8:45 am]

BILLING CODE 7590-01-M

OFFICE OF THE UNITED STATES TRADE REPRESENTATIVE

[Docket No. 30-55]

Unfair Trade Practices; Icicle Seafoods; USTR Determination and Hearing

AGENCY: Office of the United States Trade Representative.

ACTION: Notice of Section 304 Determination; Notice of Public Hearing and Request for Public Comments on Possible U.S. Action in Response to Certain Canadian Unfair Trade Practices.

SUMMARY: In May 1986, the United States Trade Representative (USTR) initiated an investigation under section 302 of the Trade Act of 1974, as amended, 19 U.S.C. 2411 *et seq.* ("the Act"), concerning Canada's prohibition on the export to the United States of unprocessed Pacific herring and pink and sockeye salmon. In March 1988, the General Agreement on Tariffs and Trade (GATT) Council of Representatives adopted a panel report finding that Canada's export prohibition is inconsistent with Canada's obligations under the GATT.

Based on the Council's findings, and because Canada continues to maintain its export prohibition, the USTR has determined under section 304(a)(1)A) of the Act, subject to the direction of the President, that Canada's export prohibition consultations with the Government of Canada. These consultations were held on September 3 and October 27, 1986. They failed to yield a satisfactory resolution of the issue. Consequently, the USTR invoked the formal dispute settlement procedures of the GATT and won a favorable panel decision that was adopted by the GATT Council in March 1988.

Representatives of the United States and Canada again consulted on March 9-11, 1988. On March 22, 1988, the Government of Canada announced that it would eliminate the export restrictions effective January 1, 1989. The Government of Canada also announced that it intended to impose new requirements for landing and inspection of certain species of fish prior to exportation.

On August 30, 1988, the USTR invited public comments, pursuant to section 304(b)(1)(A), on a proposed USTR determination regarding the Canadian export prohibition. 53 FR 33207. Canada has not as yet eliminated its export restrictions nor imposed landing and inspection requirements.

Notice of Determinations and Public Hearing

On the basis of the findings adopted by the GATT Contracting Parties, and because Canada continues to maintain the export prohibition, the USTR determined on March 28, 1989 that Canada's export prohibition denies a right to which the United States is entitled under a trade agreement. The USTR also directed the denies rights to which the United States is entitled under a trade agreement. Pending further developments in this case, the USTR has directed the Section 301 Committee to conduct a public hearing on possible U.S. action under section 301 as a result of this determination. This hearing will be held on April 26, 1989.

FOR FURTHER INFORMATION CONTACT: Questions about products under consideration for increased duties or other import restrictions should be directed to Mr. Jukka Kolhonen, U.S. Department of Commerce, (301) 427-2383. Questions concerning the status of this case, or other questions, should be referred to Mr. Peter Murphy, Assistant United States Trade Representative, Office of the United States Trade Representative (202) 395-4866.

SUPPLEMENTARY INFORMATION: On April 1, 1986, Icicle Seafoods and nine other companies with fish processing facilities in southeastern Alaska and the State of Washington filed a petition under section 301 of the Trade Act of 1974 alleging that Canada prohibited exports of unprocessed Pacific herring and pink and sockeye salmon, and that this policy was an unjustifiable trade practice in violation of Article XI of the GATT. Article XI prohibits most types of export restrictions.

On May 16, 1986, pursuant to 19 U.S.C. 2412(a), the USTR initiated an investigation on the basis of the petition (51 FR 19048). On the same date, the United States requested Section 301 Committee to conduct a public hearing pursuant to section 304(b)(1)(A) on possible U.S. action as a result of this determination.

Legal Authority

The Trade Act of 1974, as amended, requires the USTR in this case to determine under section 304(a)(1)(A) whether rights to which the United States is entitled under a trade agreement are being denied. In the event that the USTR finds that such rights are being denied, the USTR must take appropriate and feasible action in response, subject to the specific direction, if any, of the President, unless an exception specified in section 301(a)(2) applies. Section 301(c)(1)(B) expressly authorizes the USTR to impose duties or other import restrictions on the goods of a foreign country for such time as the USTR determines appropriate. Measures under section 301 may be taken against the country concerned or against all countries, at the discretion of the USTR.

Public Hearing

The section 301 Committee will hold a public hearing on a list of products exported from Canada under consideration for inclusion on a final list of products that would be subject to increased duties or other trade restrictions. The hearing will be held on April 26, 1989, at 10:00 a.m. in Court Room A, Room 100, of the U.S. International Trade Commission, 500 E Street SW., Washington, DC.

The public is invited to comment at the hearing on: (1) The appropriateness of subjecting the products listed in Annex A to an increase in duties or to other trade restrictions; (2) the levels at which U.S. customs duties or other import restrictions on particular products should be set; and (3) the degree to which increased duties or other import restrictions might have an adverse effect on U.S. consumers of the products concerned. The comments submitted will be considered in recommending any action under section 301 to the USTR.

Interested persons wishing to testify must provide written notice of their intention by noon, April 14, 1989, to Ms. Jane Bradley, Chairman of the Section 301 Committee, Office of the United States Trade Representative, Room 222, 600 17th Street NW., Washington, DC 20506. The written notice must provide the following information: (1) Name, firm or affiliation, address and telephone number; and (2) a summary of the proposed testimony, including the products, by tariff subheading numbers, to be discussed. In addition, such persons must submit a complete written statement in copies, in English, by noon, April 17, 1989, at the above address.

Remarks at the hearing will be limited to five minutes.

Persons not wishing to participate in the public hearing may submit written comments, in 20 copies, by noon, April 21, 1989, at the same address. All written comments must be filed in accordance with 15 CFR 2006.3.

A. Jane Bradley,

Chairman, Section 301 Committee.

ANNEX

HTS subheading [1]	Article description
	[The bracketed language in this list has been included only to clarify the scope of the numbered subheadings which are being considered, and such language is not itself intended to describe articles which are under consideration.]
	Fish, fresh or chilled, excluding fish fillets and other fish meat of heading 0304: Livers and roes: [Sturgeon roe]
0302.70.40	Other.
	Fish, frozen, excluding fish fillets and other fish meats of heading 0304: Livers and roes: [Sturgeon roe]
0303.80.40	Other.
	Fish fillets and other fish meat (whether or not minced), fresh, chilled or frozen:
	Fresh or chilled: [Cod, cusk, haddock, hake (*Urophycis* spp.), pollock and Atlantic ocean perch (rosefish)]
	Other: [Fresh-water fish] [Flatfish]
0304.10.4050	Other.
	Frozen fillets: [Skinned, whether or not divided into pieces, and frozen into blocks each weighing over 4.5 kg. imported to be minced, ground or cut into pieces of uniform weights and dimensions]
	Other: [Cod, cusk, haddock, hake (*Urophycis* spp.), pollock, and Atlantic ocean perch (rosefish)]
	Other: [Fresh-water fish)
	Flatfish:
0304.20.6050	Halibut
0304.20.6055	Greenland turbot (*Reinhardtius hippoglossoides*)
0304.20.6060	Other: [Wolf fish (sea catfish)]
0304.20.6090	Other.
	Other.
0304.90.10	In bulk or in immediate containers weighing with their contents over 6.8 kg each.
	Fish, dried, salted or in brine; smoked fish, whether or not cooked before or during the smoking process; fish meal fit for human consumption: Livers and roes, dried, smoked, salted or in brine: [Sturgeon roe]
0305.20.40	Other.
	Smoked fish, including fillets:
0305.41.00	Pacific salmon (*Oncorhynchus* spp.), Atlantic salmon (*Salmo salar*), and Danube salmon (*Hucho hucho*)
	Herrings, (*Clupea harengus, Clupea pallasii*): [Whole or beheaded but not otherwise processed].
0305.42.0040	Other.
	Fish, salted but not dried or smoked and fish in brine: [Herrings (*Clupea harengus, Clupea Pallasii*); cod (*Gadus morhua, Gadus ogac, Gadus macrocephalus*); anchovies (*Engraulis* spp.)].
	Other:
0305.69.40	Salmon.
	Crustaceans, whether in shell or not, live, fresh, chilled, frozen, dried, salted or in brine; crustaceans, in shells, cooked by steaming or by boiling in water, whether or not chilled, frozen, dried, salted or in brine:
	Frozen:
0306.12.00	Lobsters (*Homarus* spp.)
	Not frozen:
0306.22.00	Lobsters (*Homarus* spp.)
	Prepared or preserved fish; caviar and caviar substitutes prepared from fish eggs: Fish, whole or in pieces, but not minced:
	Salmon:
1604.11.20	In oil, in airtight containers
	Herrings: [In oil, in airtight containers] Other: [In tomato sauce, smoked or kippered, and in immediate containers weighing with their contents over 0.45 kg each]
1604.12.80	Other.
	Sardines, sardinella and brisling or sprats: In oil, in airtight containers: [Smoked sardines, neither skinned nor boned, valued $1 or more per kg in tin-plate containers, or $1.10 or more per kg in other containers]
	Other:
1604.13.20	Neither skinned nor boned
1604.13.40	Other: In immediate containers weighing with their contents under 225 grams each.
	[Tunas, skipjack and Atlantic bonito (*Sarda* spp.); mackerel; anchovies]
	Other (including yellowtail): [In airtight containers]
	Other: Fish sticks and similar products of any size or shape, fillets or other portions or fish, if breaded, coated with batter or similarly prepared:
1604.19.40	Neither cooked nor in oil.
	Caviar and caviar substitutes: Caviar substitutes: [Boiled and in airtight containers]
1604.20.40	Other.

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[1] Harmonized Tariff Schedule of the United States (USITC Publication 2030).

[FR Doc. 89-7660 Filed 3-3.-89; 8:45 am]

BILLING CODE 3190-01-M

RAILROAD RETIREMENT BOARD

Agency Forms Submitted for OMB Review

AGENCY: Railroad Retirement Board.

ACTION: In accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. Chapter 35), the Board has submitted the following proposal(s) for the collection of information to the Office of Management and Budget for review and approval.

STATEMENT OF LUZ INTERNATIONAL LTD.

SUBMITTED BY PATRICK FRANCOIS, CHIEF FINANCIAL OFFICER

Mr. Chairman and Members of the Committee, my name is Patrick Francois and I am the Chief Financial Officer of Luz International Limited, a California corporation that is the world's leading developer of solar thermal electric power plants. I want to thank the Committee for its past support of the solar industry and for providing Luz with the opportunity to present testimony on why the business energy tax credits, scheduled to expire on December 31, 1989, should be extended.

To place the business energy tax credits—and particularly the solar energy tax credit—in perspective, it is important to chronicle the growth of the solar thermal industry which could not have been achieved without the solar energy tax credit.

To date Luz has placed in service six 30 megawatt facilities and one 14 megawatt facility, all in the Mojave Desert in California, totalling 194 megawatts of electric generating capacity. The output of these facilities—which is adequate to meet the residential needs of 270,000 people in Southern California—is sold to Southern California Edison.

Unlike photovoltaics with which you may be more familiar, the basic principle of Luz technology is simply to use parabolic trough mirror assemblies to focus the heat of the sun and increase the temperature of a heat transfer fluid. Superheated fluid circulates through vacuum insulated pipes, in turn, producing steam through a conventional heat exchanger and electricity through a conventional steam turbine generator.

Luz has combined simple principles with state of the art engineering and electronics to successfully demonstrate that renewable and non-polluting solar power can meet utility standards of cost, efficiency and reliability.

Our technology has flourished in large measure because we meet a current need for peak load power. Peak demand periods in Southern California mostly fall during summer daylight periods. Luz facilities operate during 95-100 percent of the on-peak hours, 80 percent of the summer mid-peak hours and 60 percent of the winter mid-peak hours. In contrast we operate during only 13 percent of all off-peak hours.

To assure reliability even during cloudy periods and to provide power during high demand evening periods, Luz facilities are designed to operate using a limited amount of natural gas, the cleanest fossil fuel, as a supplementary source of energy.

The ability to operate on either solar or gas independently, or in a hybrid mode, makes it possible to meet baseload needs with maximum utilization of solar resources. For example, during this winter's cold spell in California we were able to alter our operating plan at the request of Southern California Edison to help meet surging demand for electricity at a time when several base load plants were off line for service.

This week we broke ground on the first 80 megawatt facility, which will be on-line by the end of 1989. The output of this facility, along with an additional 300 megawatts to be completed by 1994, will also be sold to Southern California Edison. As a result of a recent bidding exercise, we have an additional contract to build 80 megawatts of capacity for San Diego Gas and Electric and we are actively pursuing several other opportunities in the southwest United States and overseas.

When construction of our current inventory of contracts is completed, 654 megawatts of solar electric power will produce enough electricity to meet the needs of over 800,000 people—more people than live in San Francisco, New Orleans, Denver or Washington, D.C.

Moreover, solar thermal plants address positively two of the major environmental issues facing us today: ozone pollution and the so-called "greenhouse effect." The SEGS VIII plant will minimize nitrous oxide emissions which create ozone pollution by emitting only 6 parts per million of NO_x per kilowatt hour produced as opposed to 125 parts for a conventional gas fired plant. With regard to carbon dioxide emissions which produce the greenhouse effect, the SEGS plant produces only 0.27 pounds of CO_2 emissions per kilowatt hour produced as opposed to 20 pounds for a coal plant, 1.7 pounds for an oil refinery and 1.1 pounds for a natural gas facility.

Construction of our facilities and our research and development program have all been funded by private capital. This could not have been accomplished, however, without the benefit of a national policy that mitigated several critical market factors: the high risk associated with any new technology; the effect of depressed fossil fuel prices; and the capital intensive nature of a technology which costs more to build but less to operate than a conventional power plant with large fuel requirements.

We are proud of the progress that Luz has made towards commercializing solar electric power generation. But market conditions continue to require federal policy support. World energy prices continue to dampen market interest in renewable technologies, even though clean renewable power has clear public benefits. Even though the lifecycle cost of building and operating a solar power plant is becoming truly competitive with conventional fossil fuel technology, low energy prices discourage market place interest in alternatives. And under our new contracts with the utility, payments to us of so-called "avoided energy costs" costs which the utility avoids by purchasing energy from us rather than building a new plant—are projected to be only half the amounts received under the previous contracts.

Tax incentives have made it possible for us to provide adequate financial packages to attract private investment to a new technology. But with the termination of state tax benefits and the elimination of the regular investment tax credit, only the energy tax credit remains—and the energy tax credit provides the slim margin of viability for our projects. Put bluntly, without the energy tax credit our eighth SEGS project could well be our last unless there is a substantial increase in the price of oil coupled with a decrease in interest rates.

Particularly at a time when Congress is struggling to fashion policies to encourage the development of clean and safe sources of power as quickly as possible, we hope that this proven mechanism will be retained to keep private capital flowing into solar power projects. I urge you not to let a vigorous solar thermal industry die, because to resuscitate it, as will inevitably be the case when the next energy crisis arises, will cost the taxpayers subsidies far in excess of the modest cost of extending the business energy tax credits and, in any event, might not be achievable in a time frame which would make a positive contribution to the national interest.

Thank you for your consideration.

STATEMENT OF OPPOSE (ORGANIZATION FOR THE PRESERVATION OF THE PUBLIC EMPLOYEES' RETIREMENT INDUSTRY AND OPPOSITION TO SOCIAL SECURITY EXPANSION TO SUCH INDUSTRY)

SUBMITTED BY ROBERT J. SCOTT

Members of the Senate Committee on Finance, I am Robert J. Scott, secretary-treasurer of OPPOSE. OPPOSE is a Colorado corporation formed by teachers, firefighters, police, and other state and local government employees who have elected not to join the Social Security system. The purpose of our organization is to assure the continued financial integrity of our members' retirement and health insurance plans by resisting congressional efforts to mandate Social Security or Medicare coverage of public employees. Our members are found in Alaska, California, Colorado, Illinois, Kentucky, Louisiana, Massachusetts, Minnesota, Nevada, Ohio, and Texas. With respect to the issue of mandatory Medicare coverage, the interests of OPPOSE are identical to those of the four to five million public employees throughout the nation who remain outside the Social Security system.

In its budget submission for 1990, the Reagan Administration for the third time proposed to raise revenues by requiring all state and local government employees to participate in the Medicare system, effective October 1, 1989. Along with the other Reagan revenue proposals, this measure was included in President Bush's budget plan released February 9, 1989. Under the Bush plan, the revenues raised by the payment of additional Medicare taxes would apparently be used to offset some of the costs of various revenue-losing tax proposals. Through this testimony, we wish to express our strong opposition to the mandatory Medicare coverage proposal.

By way of background, I would remind you that employees of state and local governments were not permitted to join the Social Security system when it was established in 1935. While they have been permitted to join since the 1950s, those who have chosen to remain outside the system have their own retirement plans and, in many instances, health insurance plans.

In 1985, in response to the federal government's pressing need for revenues, Congress elected to require state and local governments and their employees to pay the Medicare tax. It implemented this decision, in the Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA"), by extending mandatory Medicare coverage to all state and local government employees hired on or after April 1, 1986. By adopting this phase-in provision, which is resulting in increasing numbers of Medicare-covered public employees through normal job turnover, Congress ensured that all public employees will ultimately pay the full Medicare tax to the federal government. While we at OPPOSE did not favor mandatory Medicare coverage, we believed that the phase-in provision adopted in COBRA was a reasonable, permanent solution that avoided imposing overwhelming burdens on state and local governments and their employees.

During consideration of the Omnibus Budget Reconciliation Act of 1986, Congress threatened to abandon COBRA's phase-in by mandating coverage of those employees specifically excluded from coverage under COBRA, but, in the end, did not adopt such a provision. The issue was reopened and the same proposal was rejected by Congress in 1987.

We believe that the phase-in compromise reached in COBRA should be respected and that our employees and retirees should not be visited by the same threat year in and year out. Therefore, and for the reasons set forth below, OPPOSE asks you this year to reject the proposal to extend mandatory Medicare coverage to all state and local government employees.

1. *Despite the promise of the President not to propose new taxes and the recent efforts of Congress to provide tax relief to lower- and middle-income individuals, this proposal singles out a group of 4 to 5 million lower- and middle-income Americans and their spouses for new taxes.* The President campaigned on a pledge not to raise taxes and has repeatedly asserted that the budget may be balanced without new taxes. Asked to specify what measures qualify as "new taxes," Office of Management and Budget Director Richard Darman suggested application of "the old if-it-looks-like-a-duck rule, if it looks like a 'tax' to most Americans, it's a tax."

Quite simply, this measure has webbed feet and quacks. For the 4 to 5 million affected Americans, the proposal would result in the deduction from their paychecks of approximately $363 each year. No one can deny that this is a new tax under the Bush Administration's definition. And, adding insult to injury, it is the only Administration proposal to raise income or payroll taxes!

This new tax would fall on a group of people—primarily teachers, firefighters, and police, as well as other public employees—whose income averages about $25,000 per year. This is hardly a high level of income in an era when many federal employees making almost four times this amount can not afford to remain in government service. To consider the example of the average Illinois teacher, who makes $28,085 annually, the new tax of $407 would more than offset the meager $303 that now remains to such an individual after payment of basic expenses such as rent and groceries.

Moreover, the new tax would more than offset the tax cuts these individuals received under the Tax Reform Act of 1986. According to the Joint Committee on Taxation, the Tax Reform Act provided taxpayers with incomes in the range of $20,000–$30,000 with a cut equivalent on the average to $220. The new Medicare tax that would be imposed upon state and local government employees equals 1.45 percent of payroll.

Thus, to cite another example, in the case of the average government employee in Colorado (whose annual salary is $25,842), the new Medicare tax of $375 would result in a *net tax increase* of $155. (See attached Table A setting forth state-by-state the cost of Medicare coverage to the affected individuals as well as the projected amount of his or her tax cut under the Tax Reform Act.) The increased tax burden for employees would be even higher if the 1.45 percent tax that would be newly imposed upon their employers is passed along to the employees.

2. *President Bush has vowed to leave a legacy as "the Education President," leading the effort to improve the quality of education. Yet mandatory Medicare coverage would have a particularly adverse impact upon education in America.* Within the past several years, the National Commission on Excellence in Education declared that America's educational system is failing both its students and the entire country. It has been recognized that one cause is the difficulty school systems face in recruiting and retaining quality teachers. The federal government has reported that the country will have 34 percent fewer teachers than it needs by 1992.

One reason for this problem is that teachers are significantly underpaid. In 1986–87 (the most recent year for which statistics are available), the average teacher's salary was $27,878, while the averages ranged state-by-state between $19,000 and $46,082. After adjustment for inflation, the average American schoolteacher's salary has risen only 7.3 percent over the last ten years.

Mandatory Medicare coverage would only exacerbate the problem caused by low salary levels. Teaching is one of the major professions with large numbers of noncovered members. In the affected states, mandatory Medicare coverage would take an additional $404 from the average teacher's salary each year (1.45 percent of $27,878). If, as appears likely, employers attempt to recoup their own Medicare tax obligations from their employees, the average teacher's pay cut could be double that amount. As a result, many of the best qualified teachers—particularly those with marketable skills in mathematics, science, and computers—would leave teaching for better-paid employment. In a year in which education is to take top priority, adopting legislation that would aggravate the teacher recruitment problem appears unwise.

3. *The proposal would have an extremely negative fiscal impact upon the affected state and local governments.* While the impact of the proposal would fall most heavily upon governments in approximately 10 states,* forty-nine states include at least some subdivisions with non-covered employees that would be significantly harmed by these additional operating costs. Estimates of the annual cost to state and local governments are set forth state-by-state in Table B, attached. For example, each year, the proposal would cost governments in Illinois $79 million; in Ohio, $158 million; in Maine, $14 million, and in Texas, $129 million.

Imposition of these additional costs would come at a difficult time. Recent reports released by the National Governors' Association and the National Association of State Budget Officers found that the flexible freeze called for in the Bush budget could reduce federal aid to state and local governments by as much as $5 billion and would underfund the cost of welfare reform implementation by more than 50 percent. Moreover, state and local governments have repeatedly been forced to shoulder additional burdens in recent years, resulting from considerable cuts in the federal appropriations for many of their programs and the loss of revenue-sharing, while the Tax Reform Act of 1986 limited their ability to raise revenues, through loss of the sales tax deduction and new restrictions upon municipal bonds.

The result is that state and local governments are in no shape to absorb additional fiscal burdens. Early revenue estimates for fiscal 1989 show an average revenue growth of 5.4 percent, compared with expenditure growth of 6.8 percent—a trend that could lead to further fiscal difficulties in the future. Two states that would be most seriously affected by the mandatory coverage proposal reported no revenue growth (Alaska and Louisiana), while two other such states (California and Massachusetts) reported lower-than-anticipated personal income tax collections.

To cite a few examples of the results of this fiscal squeeze, a number of California counties have been required in recent years to close public libraries and parks as a result of budget shortfalls. In 1987, the President of the Board of Commissioners for Trumbull County, Ohio, testified that, as a result of the loss of revenue-sharing, 39,000 citizens in his county were without police protection. Governments at all levels around the country would find that imposition of the new 1.45 percent Medicare tax would force them to make very hard choices among essential services and staff.

4. *Mandatory coverage of public employees will not pay for other programs because the revenues raised by the mandatory coverage proposal would shortly decline to zero, while the Bush Administration's revenue-losing proposals would require permanent sources of financing.* Through the operation of COBRA's provision imposing coverage on newly hired employees, job turnover has resulted in a larger percentage of the public employee workforce being covered each year. We estimate the overall turnover rate for state and local employee groups to be approximately 9 percent per year. Thus, of the state and local government employees not covered by Medicare before COBRA, approximately one-quarter are now covered.

As time progresses, fewer employees remain outside the system, representing a declining revenue base. The revenues that the mandatory coverage proposal would raise would dry up entirely in a relatively short time and would not be available for any purpose in the long run. On the other hand, the items that the Administration proposes to finance through mandatory coverage are permanent, and require a permanent source of financing. Enacting the spending proposals on the pretext that mandatory coverage would pay for them would actually exacerbate the deficit problem.

Moreover, because the Administration's revenue estimates do not reflect a decline in the amount that this proposal would raise over time, the estimates are themselves open to challenge even concerning the amount that would be raised in the first year. The Administration estimates that the mandatory coverage proposal would raise $1.8 billion in fiscal year 1990 and $1.9 billion in each of the next three years. These estimates, which do not reflect a decline in revenues in the out years, are simply inaccurate with respect to the later years and suggest that the full effect of COBRA was not taken into account in the estimate for fiscal year 1990.

By suggesting that mandatory Medicare coverage presents an available revenue source, the Administration's proposal also ignores the fact that the *newly taxed* individuals would also become *newly entitled* to benefits. Indeed, their benefits might well be relatively more expensive than the benefits of the average covered individual. Like the federal employees who were brought into the system in 1983, newly covered state and local government employees would become entitled to the full package of Medicare benefits despite having spent a portion of their careers outside the system and having paid a relatively small amount of the Medicare tax as a result. Given the projected decline in the HI trust fund's balance in the next decade, any revenues raised by an expansion of mandatory Medicare coverage would be needed to offset the cost of additional benefits.

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* Alaska, California, Colorado, Illinois, Louisiana, Maine, Massachusetts, Nevada, Ohio, and Texas.

Recent reports have indicated that the magnitude of the deficit problem the country faces in the next decade is masked, in part, because the Social Security trust funds, which are counted for purposes of deficit calculation, will begin to build large surpluses that must be expended on benefits in the next century. Congress should not add to this problem by enacting spending proposals and claiming to fund them by revenues which are credited to the HI trust fund and necessary to pay future benefits.

5. *Mandatory Medicare coverage of the employees who were "grandfathered" outside the system by COBRA would create a variety of problems that were avoided by COBRA's compromise position.* Some state and local governments have health plans in place for their employees, including retirees. Adjustment of these plans to take account of Medicare coverage for existing employees would prove an overwhelming task, or would result in abandonment of these plans. While COBRA affects the health benefits and take-home pay of individuals at the time they commence employment, the current proposal would displace benefits programs that individuals have enjoyed, in some cases, for many years, and would reduce the amount of take-home pay they have come to expect. Abandonment of the careful compromise adopted in COBRA would unfairly disappoint the expectations of millions of public workers.

6. *Mandatory coverage can not be justified on the grounds that it would benefit the affected employees.* The Reagan Administration attempted to justify its proposal with the paternalistic concern that "[a] minority of State and local government employees . . . may not be assured of Medicare coverage." The response to this concern is simple: if those public employees wanted Medicare coverage, they would have it. Since the passage of COBRA, local jurisdictions have had the option of joining the Medicare system without also participating in the Social Security system. If Medicare coverage were desirable, employees would certainly bring pressure to bear upon their employers to adopt it. In fact, the opposite is true; public employee groups are vehemently opposed to mandatory Medicare coverage and do not need the federal government to provide it "for their own good."

TABLE A.—ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYEES OF MEDICARE COVERAGE OF ALL EMPLOYEES

State	Annual salary of average public employee [1]	Annual tax increase resulting from proposal [2]	Average tax decrease resulting from the Tax Reform Act [3]
Alabama	$20,004	$290	$220
Alaska	39,672	575	273
Arizona	28,044	407	220
Arkansas	18,060	262	200
California	32,700	474	273
Colorado	25,608	371	220
Connecticut	27,708	402	220
Delaware	24,132	350	220
Dist. of Columbia	32,472	471	273
Florida	23,616	342	220
Georgia	20,400	296	220
Hawaii	23,460	340	220
Idaho	19,908	289	200
Illinois	26,496	384	220
Indiana	24,996	362	220
Iowa	23,064	334	220
Kansas	20,856	302	220
Kentucky	19,692	286	200
Louisiana	18,768	272	200

TABLE A.—ANNUAL COST TO STATE AND LOCAL GOVERNMENT EMPLOYEES OF MEDICARE COVERAGE OF ALL EMPLOYEES—Continued

State	Annual salary of average public employee [1]	Annual tax increase resulting from proposal [2]	Average tax decrease resulting from the Tax Reform Act [3]
Maine	20,724	301	220
Maryland	27,540	399	220
Massachusetts	26,076	378	220
Michigan	28,848	418	220
Minnesota	29,340	425	220
Mississippi	16,656	242	200
Missouri	21,300	309	220
Montana	21,588	313	220
Nebraska	20,592	299	220
Nevada	26,208	380	220
New Hampshire	21,636	314	220
New Jersey	27,348	397	220
New Mexico	20,640	299	220
New York	29,160	423	220
North Carolina	22,140	321	200
North Dakota	22,056	320	220
Ohio	24,516	355	220
Oklahoma	19,752	286	200
Oregon	24,504	355	220
Pennsylvania	24,132	350	220
Rhode Island	27,036	392	220
South Carolina	19,752	286	200
South Dakota	18,828	273	200
Tennessee	20,184	293	220
Texas	21,924	318	220
Utah	21,912	318	220
Vermont	21,768	316	220
Virginia	23,172	336	220
Washington	26,616	386	220
West Virginia	19,368	281	200
Wisconsin	25,620	371	220
Wyoming	23,268	337	220

[1] U.S. Bureau of the Census, Public Employment in 1987—Government Employment (Series GE–87–1) at 10.

[2] The amount of the new Medicare tax is derived by multiplying the average employee's salary by 1.45%.

[3] Joint Committee on Taxation Staff, Data on Distribution by Income Class of Effects of H.R. 3838, Tax Reform Act of 1986 (JCX–28–86) (October 1, 1986), Table 4.

TABLE B.—POTENTIAL ANNUAL COST TO STATE AND LOCAL GOVERNMENTS OF COVERAGE OF THOSE EMPLOYEES CURRENTLY NOT COVERED BY MEDICARE

State	Employees not covered by Social Security [1]	Employees not covered by Medicare		Cost of coverage (in millions of dollars) [3]
		Number [2]	Percentage [2]	
Alabama	27,000	19,710	8.2	7.2
Alaska	40,000	29,200	51.5	10.6
Arizona	21,000	15,330	8.2	5.6
Arkansas	39,000	28,470	9.7	10.3
California	991,000	723,430	47.1	263.0
Colorado	150,000	109,500	56.7	39.8
Connecticut	63,000	45,990	27.6	16.7
Delaware	14,000	10,220	25.4	3.7
Florida	127,000	92,710	15.7	33.7
Georgia	64,000	46,720	13.5	17.0
Hawaii	24,000	17,520	24.7	6.4
Idaho	0	0	0	0
Illinois	299,000	218,270	35.9	79.3

TABLE B.—POTENTIAL ANNUAL COST TO STATE AND LOCAL GOVERNMENTS OF COVERAGE OF THOSE EMPLOYEES CURRENTLY NOT COVERED BY MEDICARE—Continued

State	Employees not covered by Social Security [1]	Employees not covered by Medicare		Cost of coverage (in millions of dollars) [3]
		Number [2]	Percentage [2]	
Indiana	54,000	39,420	12.7	14.3
Iowa	5,000	3,650	1.5	1.3
Kansas	2,000	1,460	0.7	0.5
Kentucky	56,000	40,880	20.1	14.9
Louisiana	271,000	197,830	63.4	71.9
Maine	52,000	37,960	53.0	13.8
Maryland	29,000	21,170	7.5	7.7
Massachusetts	334,000	243,820	74.6	88.6
Michigan	19,000	13,870	3.0	5.0
Minnesota	96,000	70,080	24.7	25.5
Mississippi	2,000	1,460	0.7	0.5
Missouri	62,000	45,260	16.4	16.5
Montana	5,000	3,650	6.7	1.3
Nebraska	2,000	1,460	1.5	0.5
Nevada	49,000	35,770	70.2	13.0
New Hampshire	6,000	4,380	7.5	1.6
New Jersey	30,000	21,900	4.5	8.0
New Mexico	33,000	24,090	20.1	8.8
New York	153,000	111,690	8.9	40.6
North Carolina	43,000	31,390	8.2	11.4
North Dakota	6,000	4,380	7.5	1.6
Ohio	595,000	434,350	74.6	157.9
Oklahoma	33,000	24,090	11.2	8.8
Oregon	14,000	10,220	5.2	3.7
Pennsylvania	36,000	26,280	4.5	9.6
Rhode Island	25,000	18,250	32.1	6.6
South Carolina	6,000	4,380	2.3	1.6
South Dakota	2,000	1,460	3.7	0.5
Tennessee	29,000	21,170	8.9	7.7
Texas	486,000	354,780	37.3	129.0
Utah	1,000	730	0.7	0.3
Vermont	1,000	730	1.5	0.3
Virginia	72,000	52,560	13.5	19.1
Washington	36,000	26,280	9.7	9.6
West Virginia	7,000	5,110	4.5	1.9
Wisconsin	48,000	35,040	11.9	12.7
Wyoming	5,000	3,650	7.5	1.3
TOTAL	4,564,000	3,331,720		$1211.2

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[1] Social Security Administration, 1985 Current Population Survey and Continuous Work History Sample, reprinted in Congressional Research Service paper "Medicare Coverage of Employees of State and Local Governments;" by David Koitz, (March 11, 1987).

[2] The Consolidated Omnibus Budget Reconciliation Act of 1985, Publ. L. 99–272, requires public employees hired after March 31, 1986, to participate in the Medicare system. Because we assume employee turnover occurs at a rate of approximately per year, in the three years since COBRA took effect, approximately 277 of previously non-covered public employees are now covered by Medicare. The number of public employees not covered by Social Security has therefore been reduced by 277 to reflect the number of employees who are currently not covered by Medicare.

[3] The figures reflect only the 1.45% that would be paid by the governments as employers, and do not include the cost increase to their employees, who would also have to pay the 1.457 Medicare tax (see reverse side for increased tax burden on individual employees). Given that the employer's part of the Medicare tax is 1.457, and the salary of the average state or local government employee is $25,068, (U.S. Bureau of the Census, Public Employment in 1987—Government Employment (Series GE–87–No. 1) at 10), each governmental employer's cost is equal to the number of employees, multiplied by $25,068, multiplied by 1.45%.

STATEMENT OF ROBERTS, LOUCKS & CO. A CORPORATION, PRIVATE INVESTMENT ACCOUNTS

Dear Friends: The following recommendations are submitted in connection with your current hearings on the capital ins tax. Thanks to your staff for inviting me to present my views and careful directions thereof.

The U.S. capital gains tax, I am told, is the highest in the world. When you add state taxes on gains in high tax states such as Massachusetts, New York and California it is even higher, exceeding 40% for some taxpayers.

We are investment advisors mostly to individuals and families with nearly $300 million total. Our clients are located in many states from Vermont to Alabama, Florida and California, etc. We have been advising people on investments in Chicago since the 1920's through predecessor firms.

Every week of every year we are constantly advising investors whether to realize gains on stocks they consider no longer suitable for their own objectives. We took gains freely and flexibly with the previous law before 31 December 1986. We do not and cannot now. There is no question in my mind that our clients would pay considerably more gains taxes if the rates were lower not only for one year but for many years. Until that happens (lower rates) we are going to hold off on realizing most gains we would like to take. My recommendations are as follows:

1. Increase taxes from zero for tax-free investors (such as endowments and pension funds) for securities sold in less than one year to a rate of 5% under one year and 10% under six months. These traders are engaging in a business and do not seem to me to qualify as tax-free investors.
2. Reduce the gains tax for tax-paying investors to allow for some sort of inflation indexing formula on sale of investments and principal residence, e.g. maximum 22% on holding periods over two years and 16% over five years. I believe that considerably higher tax revenues would be received at these rates. Also our clients would have better flexibility of investment and be encouraged in venture capital and investment in smaller, newer companies.

The idea of special treatment for gains with holding periods of over six or twelve months may help stock trading. I think it has doubtful benefits for investors who save and keep the economy supplied with capital. The idea of long-term capital gain at six months is absurd and encourages all kinds of wasteful tax-shelter schemes to convert income to gains in only six or twelve months. We have a stock brokerage affiliate which does considerable stock trading for individual tax-payers. I am giving a fair, objective opinion.

Why do investors save less in the U.S.? The gains taxes discussed above are a major deterrent. Also the after-tax, after-inflation results of saving are not very good, particularly if the investor must spend 5% or more of his capital each year. For this I enclose an article we prepared.

Sincerely yours,

WILLIAM J. ROBERTS C.F.A., *Managing Director*

Enclosure

INVESTING AND SPENDING CONSERVATIVELY SINCE 1968 AND 1972 1987 PURCHASING POWER OF INVESTMENTS LOWER

Investors for many years have been accustomed to seeing performance measurement of stock and bond portfolios *assuming reinvestment of all income. Purchasing power* of a Standard & Poor's 500 stock, weighted-index, *income-reinvested* portfolio would be 51% higher at the end of 1987 than the previous peak at the end of 1972. Nominal dollar wealth ratio (*without* Consumer Price Index adjustment for inflation and reduced purchasing power) would be 310% higher than 1972.

We are indebted to Peter L. Bernstein of New York for his article in the Financial Analysts Journal of July, 1988, for pointing out the following: a *5% income cash withdrawal rate each year* from a 60–30–10 portfolio (60% S&P 500, 30% long-term Treasury bonds and 10% Treasury 90-day bills) would result in lower portfolio purchasing power at the end of 1987 compared to *any* year from 1925 to 1972!

Using the 1979–82 low, real wealth ratio (adjusted for inflation) was about 405 below the levels at the end of 1925, 1930, 1941, 1953 and 1973 with a 55 annual withdrawal rate from Bernstein's balanced portfolio. The 1985–86 rise in the stock market reduced this purchasing power decline to about −19% at the end of 1987. Even worse, the purchasing power of this balanced portfolio at the end of 1987 was about 42% below the levels the portfolio had reached in the 1955–68 golden period.

RESULTS FROM ALL STOCKS

We thought it would be useful to look at several other investor alternatives. What if our investor had 100% of his savings in the S&P 500 to capture the more volatile but long-term higher returns of common stocks? The attached graph shows results since 1960. A 5% annual withdrawal rate leaves him well below his purchasing power levels of 1960–72. Only if he reduces his withdrawal rate to 3% annually has he maintained purchasing power. Even with only 3% withdrawn annually he lost purchasing power from 1960–73 to 1974–84. How many retired investors, endowment funds and other purchasing-power investors could or did live on 3% a year?

RESULTS FROM 5-YEAR TREASURIES

Here is another realistic example: a conservative investor who shuns the volatility and uncertain annual returns of both common stocks and long-term bonds. This investor concentrated solely on a portfolio each year of U.S. Treasury bonds of average maturity five years. He avoids the usual reduced yield of shorter-term investments and the much more volatile total returns of long-term bonds. The investor also avoids all state income taxes if a tax-payer.

Such an investor is even *worse off!* The purchasing power of his 5-year Treasury portfolio after 5% cash income withdrawal annually declined steadily after the first year, 1960. The real wealth ratio bottomed out for a few years from 1969–72 and then sank to a saucer shape from 1977–78 to 1986–87. At the 1981 bottom this portfolio had *lost over 69%* of its purchasing power. At the end of 1987 the wealth ratio was still 56% below the 1960 level and 365 below the 1972 level. The 3% annual withdrawal index was 13% below the 1972 level. The 5% annual withdrawer has maintained purchasing power since 1978 before federal income taxes.

RESULTS AFTER FEDERAL TAX

For a taxpayer, see the accompanying graphs showing results for tax-free municipal bond portfolios with average maturity of 5 and 10 years. The investor who withdrew 5% annually from the 5-year portfolio suffered over a *70% loss of purchasing power* from the beginning of 1972 to the end of 1981. He has maintained purchasing power since the 1980–81 level. The investor in 10-year tax-free bonds withdrawing only 5% annually has lost about 44% of purchasing power since Jan. 1, 1978, but has held about even since 1980. Conclusion: investors withdrawing more than 5% have been losing purchasing power. "A major reason we Americans save so little is that taxes still take most of the real return on additional savings"—see Prof. Martin Feldstein, "A National Savings President", Wall St. Journal, Nov. 21, 1988.

ASSET ALLOCATION

What about tactical asset allocation shifting and market timing? Recent years' actual experiences in asset allocation are a disciplined optimizer approach compared to intuitive market timing and may be of benefit. Rex Sinquefield and David Booth presented simulations ("Market Timing: Costs and Benefits", University of Chicago Graduate School of Business CRSP seminar, May, 1985) of investors shifting between stocks, cash equivalents and long bonds. We are impressed with their conclusion that the shifter has to be correct in his allocation decisions over 605 of the time in order to equal the buy-hold return.

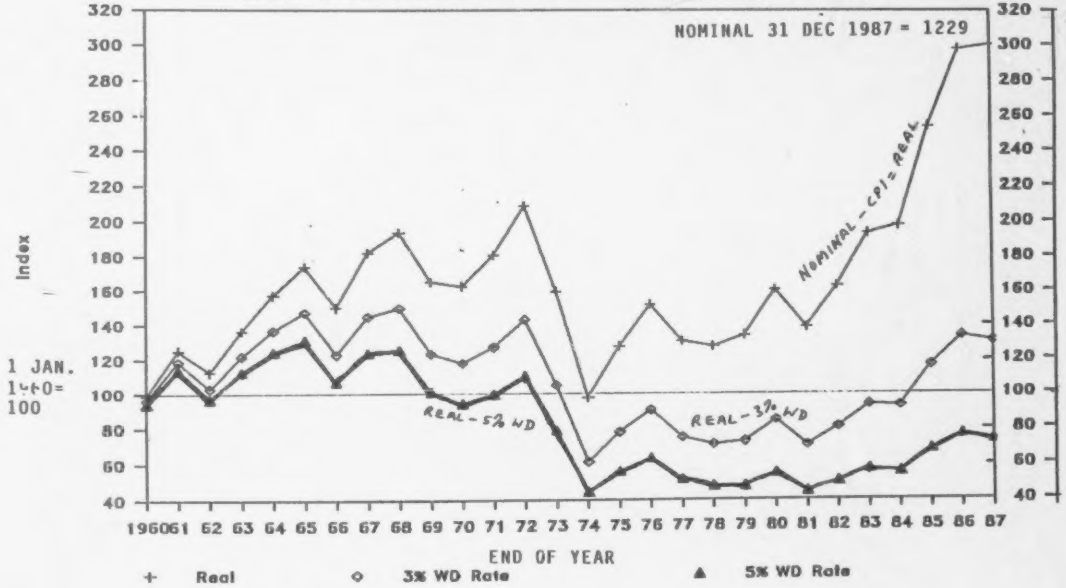
Withdrawals, inflation and taxes greatly reduce the compounding of reinvestment. The investor who makes withdrawals and wishes to maintain purchasing power of principal has to aim for better stock results than the S&P 500 and not demand too much cash income flow from the bond portion of his balanced, diversified portfolio.

November, 1988

Roberts, Loucks & Co.
A CORPORATION

CUMULATIVE WEALTH RATIO

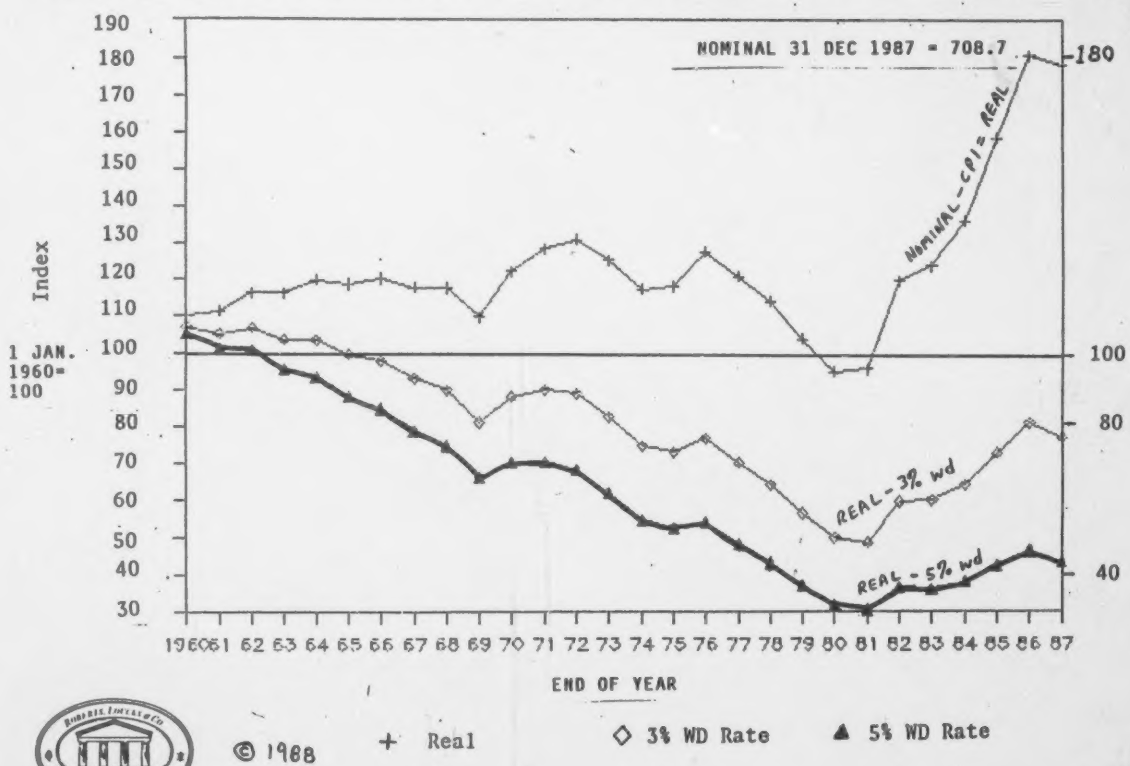
COMMON STOCK TOTAL RETURNS (S&P 500.DIV. REINV. ± ΔPRICE)



Roberts, Loucks & Co.
A CORPORATION

CUMULATIVE WEALTH RATIO

INTERMEDIATE TERM BOND TOTAL RETURNS (5-Year U.S. TREASURY BONDS INC. REINV.±ΔPRICE)



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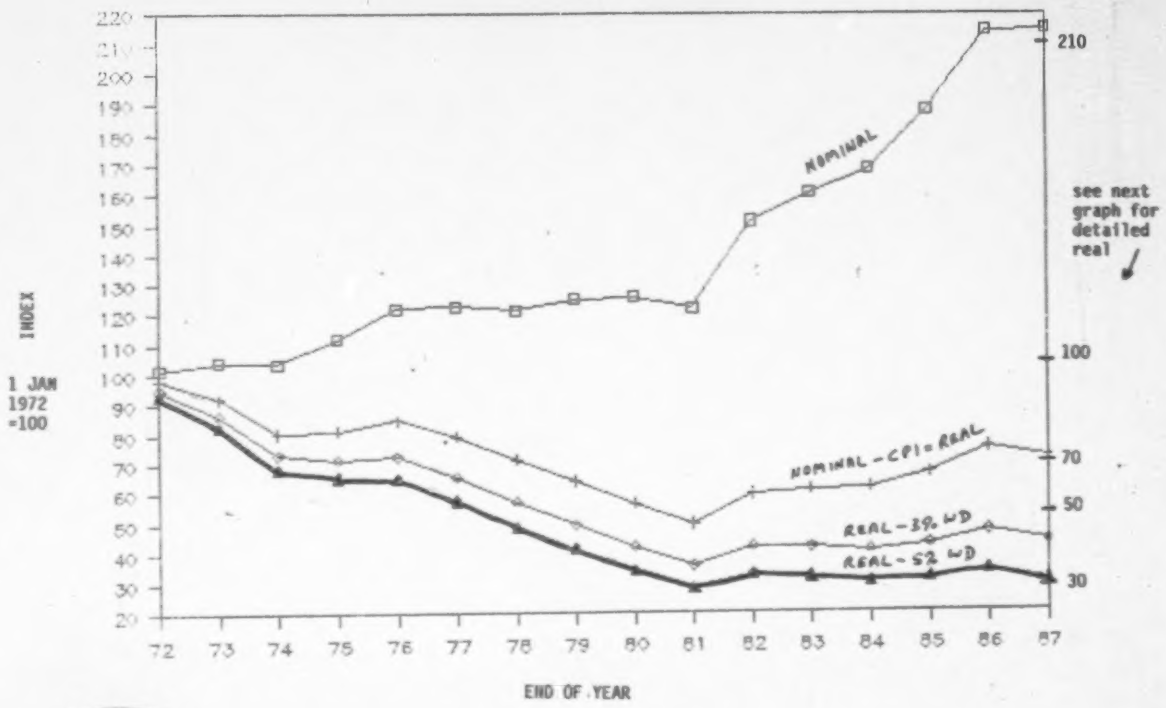
TAX-FREE MUNICIPAL BOND PORTFOLIO
AVERAGE LIFE 5 YEARS AA(JOHN NUVEEN & CO.
ESTIMATED)TOTAL RETURN EACH YEAR (COUPON ± PRICE CHANGE)



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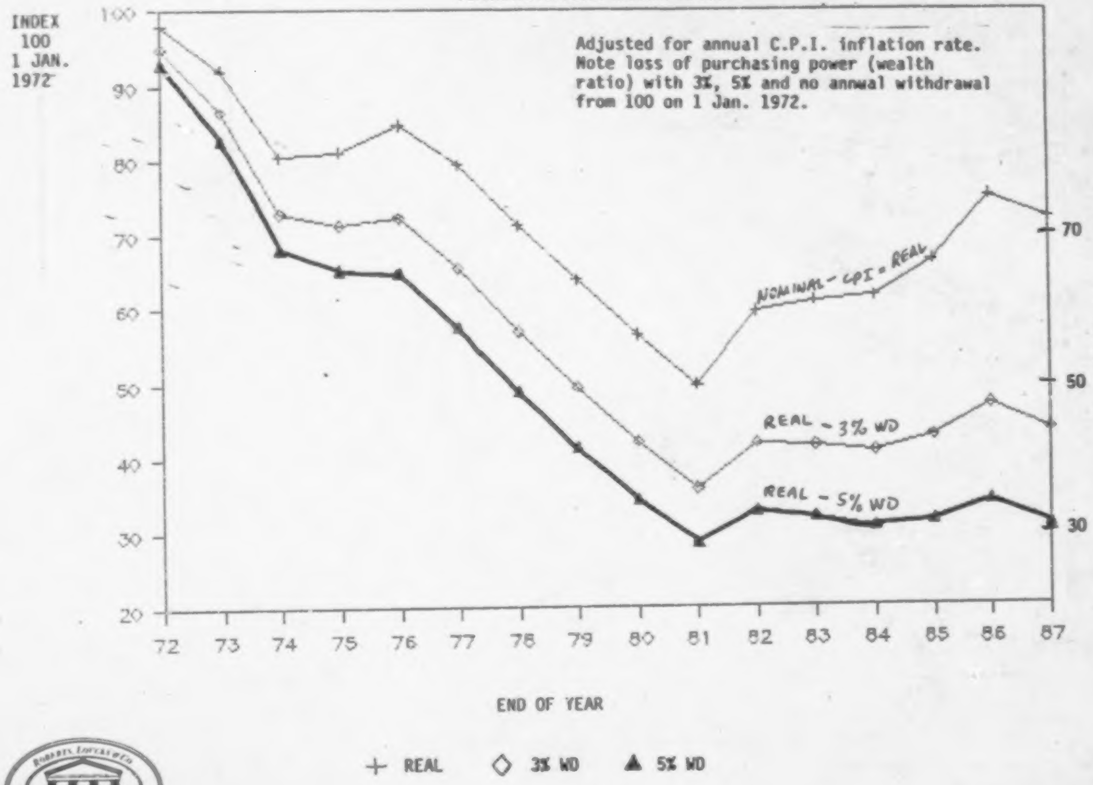
TAX-FREE MUNICIPAL BOND PORTFOLIO
AVERAGE LIFE 5 YEARS AA (JOHN NUVEEN & CO.)
ESTIMATED TOTAL RETURN EACH YEAR (COUPON ± PRICE CHANGE)
CUMULATIVE REAL WEALTH RATIO



Adjusted for annual C.P.I. inflation rate. Note loss of purchasing power (wealth ratio) with 3%, 5% and no annual withdrawal from 100 on 1 Jan. 1972.

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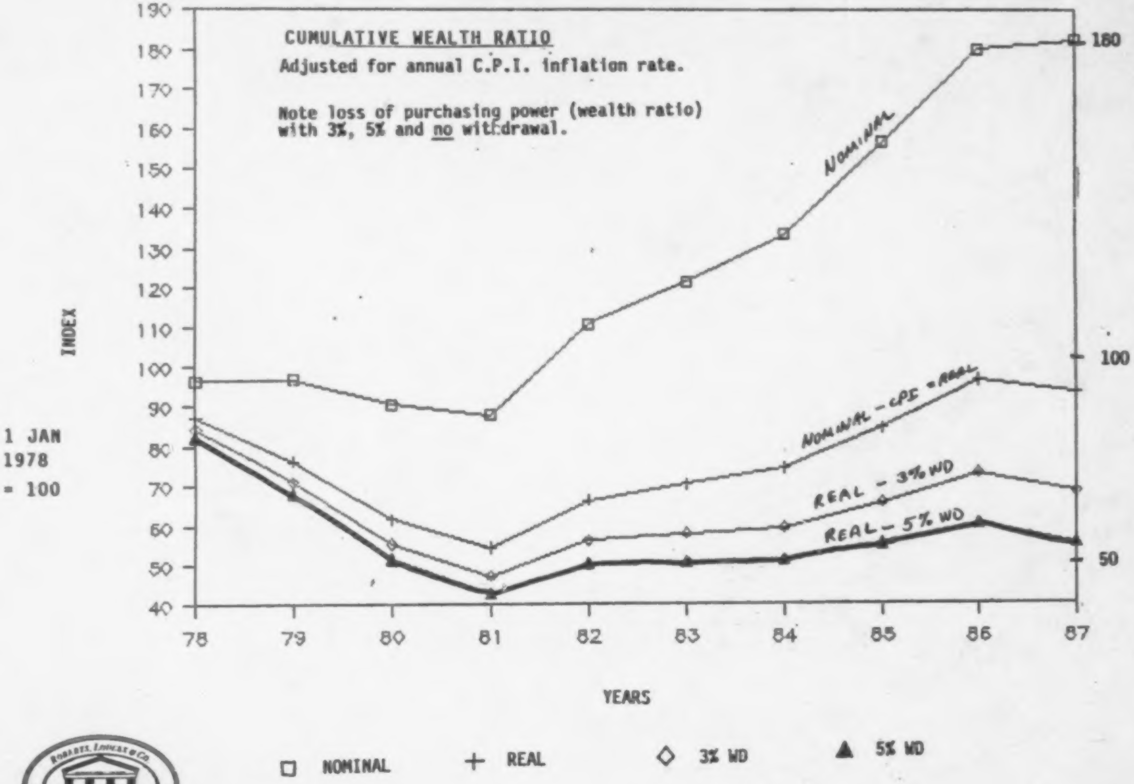
FIDELITY LIMITED TERM MUNICIPALS
AVERAGE MATURITY ESTIMATED 10 YEARS


CUMULATIVE WEALTH RATIO
Adjusted for annual C.P.I. inflation rate.

Note loss of purchasing power (wealth ratio) with 3%, 5% and no withdrawal.

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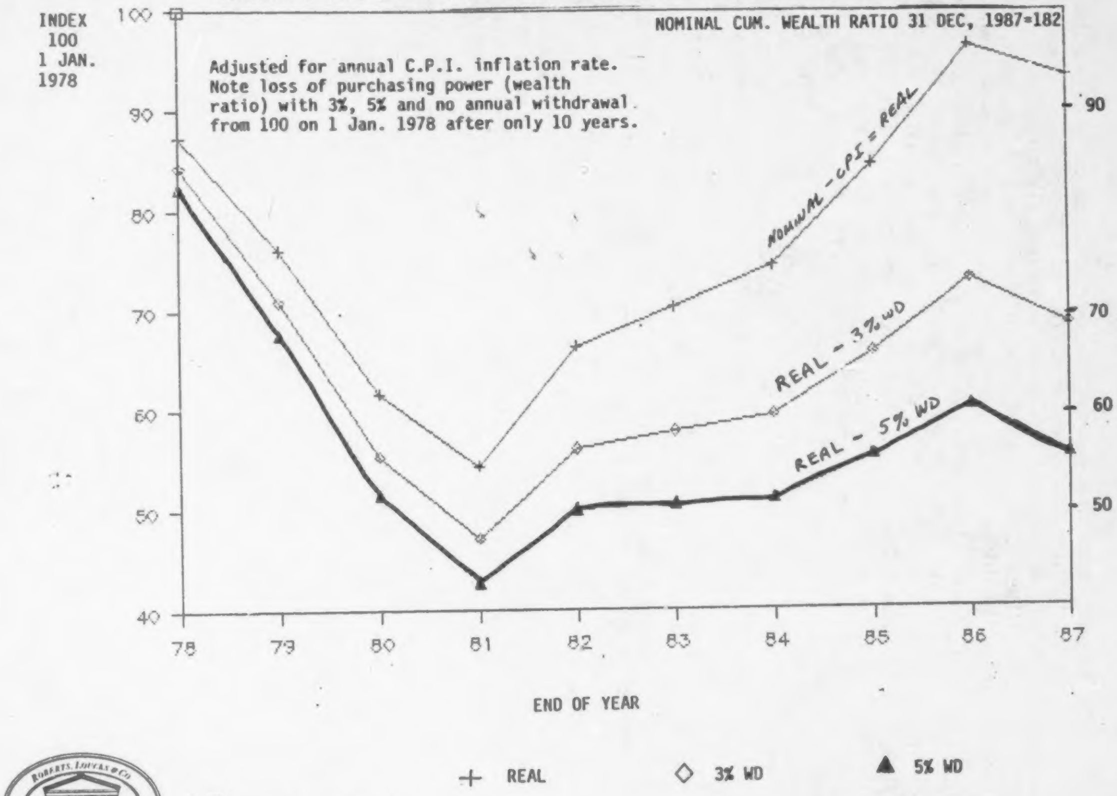
FIDELITY LIMITED TERM MUNICIPALS
AVERAGE MATURITY ESTIMATED 10 YEARS
CUMULATIVE REAL WEALTH RATIO AFTER ANNUAL TOTAL RETURN (COUPON ± PRICE CHANGE)


NOMINAL CUM. WEALTH RATIO 31 DEC, 1987=182

Adjusted for annual C.P.I. inflation rate. Note loss of purchasing power (wealth ratio) with 3%, 5% and no annual withdrawal from 100 on 1 Jan. 1978 after only 10 years.

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STATEMENT OF SEIA (SOLAR ENERGY INDUSTRIES ASSOCIATION), SUBMITTED BY SCOTT SKLAR, EXECUTIVE DIRECTOR

INTRODUCTION

The Solar Energy Industries Association, the national trade organization of the photovoltaic and solar thermal manufacturers and component suppliers, urges the U.S. Congress to extend the solar business energy tax credits at the current 10 percent level through December 31, 1991. The federal incentive has been an effective market primer to facilitate 200 megawatts of solar thermal power, thousands of solar water heating installations, and selective use of photovoltaics nationwide. Currently Japan and many of our other international competitors are using tax and other market incentives to build their domestic solar energy industries.

While the Administration opposes this tax incentive extension due to "substantial" solar federal research and development programs, the fact is that solar federal research programs have been cut by 80 percent over the last eight years. As a result, both Japanese and German government solar research programs have surpassed that of the United States by over 30 percent which threaten U.S. technical predominance. No industry, including the U.S. solar industries, can maintain their competitive advantage if they are unable to expand their domestic markets.

The solar industry is a microcosm of any high-technology industry. How will the United States commercialize the research in which it has spent millions of dollars? Will the United States succumb to "VCR Syndrome"? This syndrome is where the United States invests millions of dollars in research and then allow our international competitors to commercialize the technology to reap billions of dollars and millions of jobs. Maintenance of solar business energy tax credits, tied to level solar R&D funding, is the most effective formula for successful commercialization. This formula has been effectively proven in solar thermal power applications, and will shortly do so in photovoltaic and solar water heating applications. However, if the U.S. Congress fails to extend these tax incentives, the United States risks the probability of importing all our solar technologies from our international competitors within a decade.

The choice is ours-whether we will further commercialize solar energy and maintain our technological lead-or whether we will abdicate our technological leadership to our international competitors? Extension of the solar business energy tax credits requires minimal revenue loss, and will create a billion dollar industry with millions of jobs, if the solar industry is allowed to mature.

HISTORY

Title I of The Energy Tax Act (P.L. 95–618), established the ten percent solar business investment credit which was to expire on December 31, 1982. At the time, there were virtually no photovoltaic or solar thermal power installations and a few hundred commercial solar water heating installations. The Windfall Profits Tax Act of 1980 (P.L. 96–223) extended the solar business tax credit through December 31, 1985 at the 15 percent level. In the Tax Reform Act of 1986, the solar business commercial credits were extended retroactively from January 1, 1986 through December 31, 1988 at the 10 percent level. By this time commercial sales (excluding residential and export sales) of photovoltaics reached $5 million, solar water heating reached $10 million, and solar thermal power reached $200 million in 1988.

And in the 100th Congress, an amendment was introduced on the Senate floor as part of the Technical Corrections Act of 1988 which extended the 10 percent solar business energy credits through December 31, 1989.

These piecemeal extensions at the eleventh hour adversely effect the development of the solar energy industry in the United States. Potential loss of the credits deters private investment until the issue is resolved by the Congress. The Solar Energy Industries Association (SEIA) request for a three-year extension at the 10 percent level, will lower the "new" technology risk while still allowing market forces to determine the most cost effective use of solar.

While the tax incentives are not large enough to offset market forces, they do compensate the investment risk marginally, which is adequate at this point in our development to incentive projects. Without continued solar research and development, and incentives to allow interconnection to the utility grid, the tax incentives alone will not do the job. However, maintaining tax incentives are essential if the United States is to commercialize the solar technologies. The revenue loss estimates by the Administration appear high, and our industry estimates half the revenue loss predicted by the Administration.

According to a study prepared in March 1985 for SEIA by economist Robert R. Nathan titled, "The Development of Solar Energy and Federal Income Tax Credits", Mr. Nathan states, "Without further technologically based innovations and economies-of-scale advantages, necessary cost reductions cannot be attained."

STATE OF SOLAR INDUSTRY

Photovoltaics, the conversion of sunlight directly to electricity, has come down ten-fold in costs in the last decade while efficiency has increased four-fold. Photovoltaic sales topped $100 million in 1988 with 65 percent of U.S. photovoltaic equipment exported to the developing world to provide power for medical refrigerators, water pumping and irrigation, communications, and lighting. Many of the utilities in the United States are looking towards photovoltaics to provide remote power in the utility service area for sign and street lighting and even to country homes. Photovoltaics for utility peak power will be seen before 1990 if the tax incentives are maintained, for there are several privately-financed projects in the pipeline now. In 1989 sales are expected to increase by 25 percent.

Solar water heating is the most common solar technology in the market place. Over one million homes in the United States use solar water heaters. And while that sounds like a large number of solar applications over the last fifteen years, the City of Tokyo alone has an equal number of solar water heaters. Most of the solar water heaters are rated by the Solar Rating & Certification Corporation (SRCC) a non-profit organization established by the solar industry and state government energy officials. SRCC has developed a solar system certification that meets the HUD Minimum Property Technical Standards. In 1988, SEIA/ASHRAE with support of the U.S. Department of Energy has published a commercial-scale design manual which draws from over ten years experience of the industry and federal researchers, to show the best way to design large-scale, cost effective, commercial solar projects. In 1989, sales are expected to increase by 15 percent.

Solar thermal power, which concentrates sunlight to create steam, which in turn can be used to generate electricity is cost effective today. As stated earlier in this testimony, the United States has the largest privately-financed solar thermal power facilities generating 200 megawatts of utility-grade electricity in California. Over 500 megawatts will be generated over the next two years with costs already below that of nuclear energy generation. In 1989, sales are expected to increase by 50 percent.

After years of research, solar energy is finally being commercialized. Extending solar business energy tax incentives at the current 10 percent level will insure this commercialization continues.

CONCLUSION

After years of research, solar energy is finally being commercialized. Extending solar business energy tax incentives at the current 10 percent level will insure that this commercialization continues. But the United States is not the only industrialized nation attempting to commercialize solar technology.

The European Consortium, Phoebus, is attempting to build a 30 megawatt solar thermal power plant in Jordon as a first step in building the Middle East market. The European Community has established a $30 million tied- aid fund to allow drought-stricken North Africa countries to purchase European photovoltaic water pumping equipment. This incentive alone will allow the smaller European photovoltaics industry, now producing only a fraction of our PV-manufacturing capacity, to potentially surpass the total United States photovoltaic manufacturing output within the next three years. And Japan still retains. market incentives and mandatory building requirements for solar water heating which has made their solar water heating industry the largest in the world.

The United States must rise to meet this challenge. Mr. Nathan stated in his aforementioned study, "However, without prospective higher volume of demand, solar manufacturers have little incentives to invest in larger-scale manufacturing facilities." Without larger facilities achieving certain economies of scale, our industries will not be able to lower our costs to become more competitive. Such economies of scale were needed by the semiconductor and computer industries which were assisted by the government through large- scale government procurement by the military. A similar approach will be adopted for high resolution imaging.

The solar energy industries are no less important as a high technology investment for the United States. Energy is essential for any country to remain competitive. Any country that leads in energy conversion technologies, will lead the world economically. So far, every industrialized nation has increased its government solar research and development program while the United States has drastically cut our own research efforts. Most of our competitors have a wide range of solar market incentives involving mandatory building requirements, tax incentives, import tariffs and tied-aid projects to vigorously promote exports. Therefore, the loss of our domestic solar business energy tax credits, will seriously undermine our industries' international competitiveness which may be irreversible.

The 1989 year will be a turning point for the United States solar industries. If federal research and development is cut further, tax credits allowed to expire, and incentives for utility interconnection placed in regulatory limbo by the Federal Energy regulatory Commission (FERC) the United States solar energy industries will be subsumed by our international competitors.

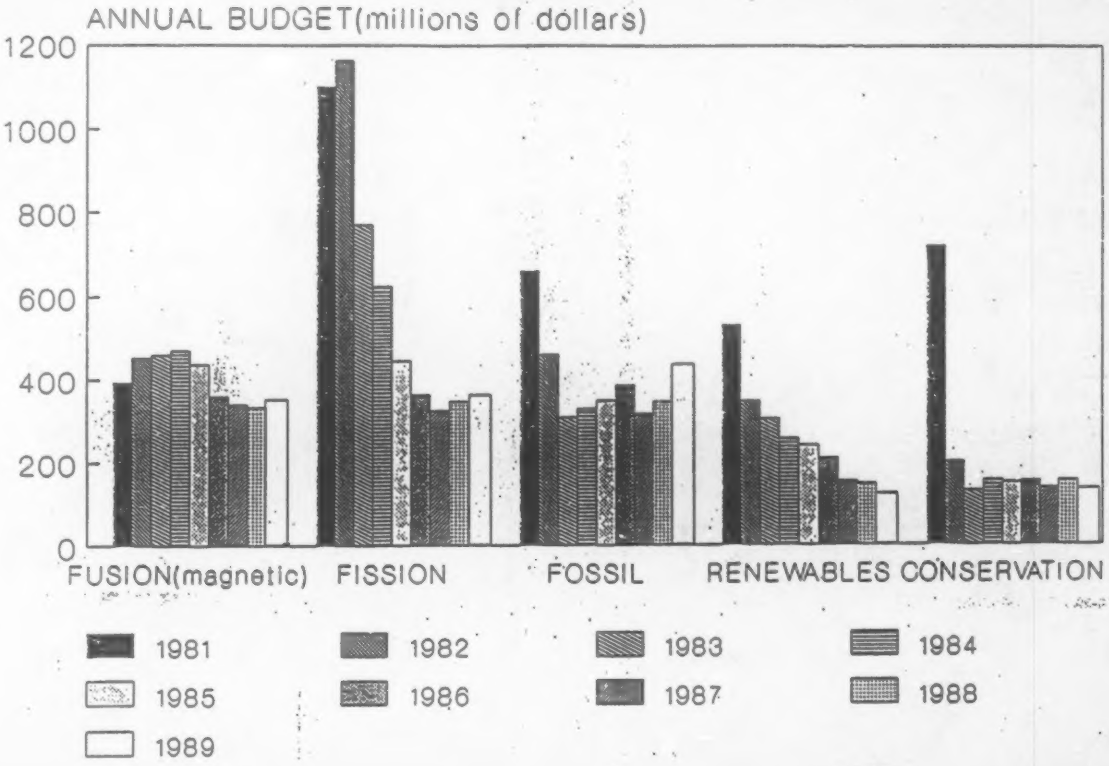
However, if federal research and development programs are maintained and tax credits are extended, the United States solar energy industries will be the showcase of the world. We are the only nation that has shown that the private sector can successfully develop solar thermal power at the 200 megawatt level. Concerns about the effects of burning fossil fuels on global climate makes solar energy development an important. Concerns about the United States as a technology leader, makes solar energy development critical to our country's international competitiveness.

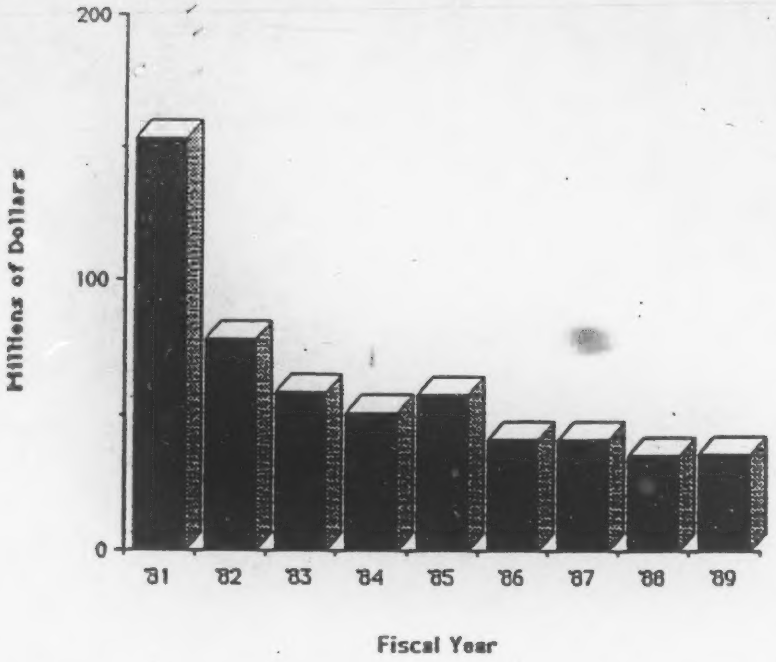
But most important, the United States taxpayer has invested millions of dollars to develop solar energy and the United States has been faulted in the past for not having the commitment to stick with technology development to the commercialization stage. There is no reason for the United States to follow the VCR Syndrome path in solar energy. The revenue loss is minimal, the market and environmental benefits are staggering, the employment creation potential is large, and energy to be delivered is significant.

The Solar Energy Industries Association on behalf of the U.S. solar energy industries urges the U.S. Congress to extend the solar business energy tax credits at the current 10 percent level through December 31, 1991. If the U.S. Congress meets this request, the results will be profound. Thank you.

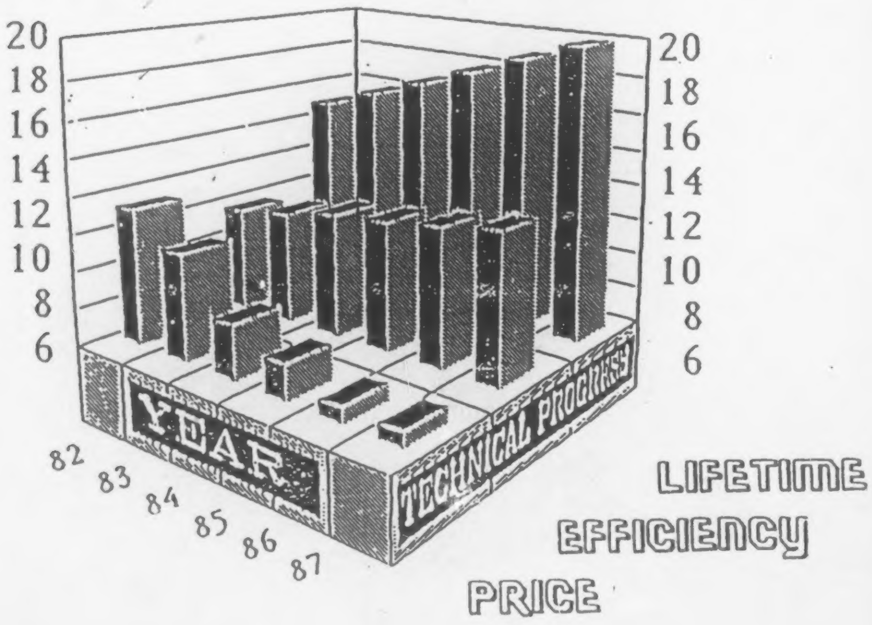
Enclosure

ANNUAL APPROPRIATIONS OF DOE CIVILIAN R&D PROGRAMS (current dollars)

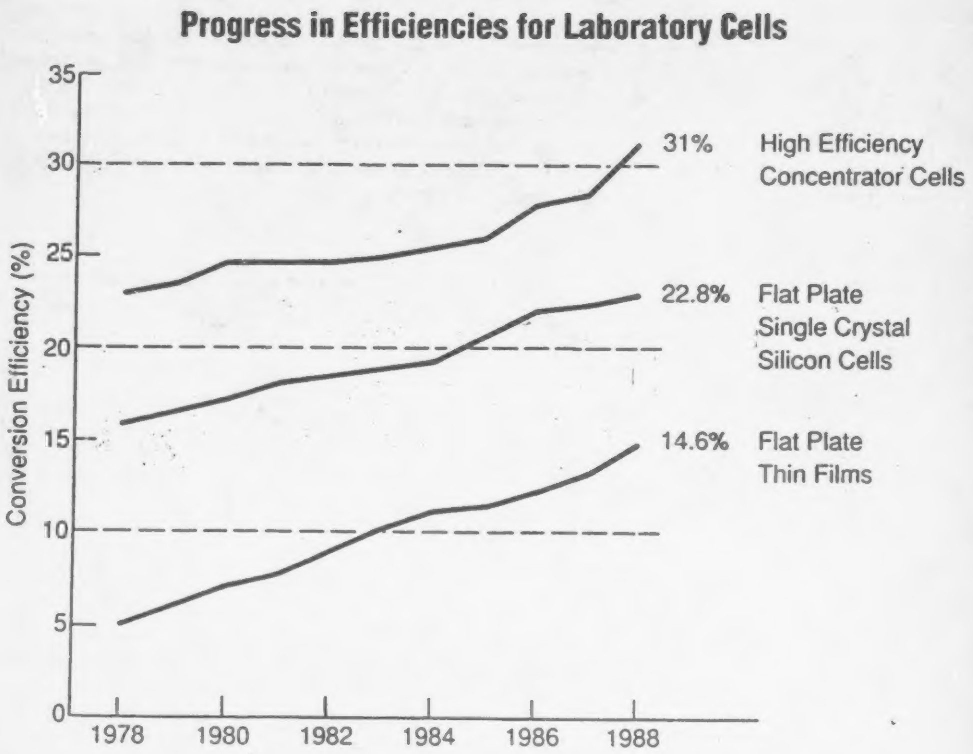




Federal R&D Funding for Photovoltaics

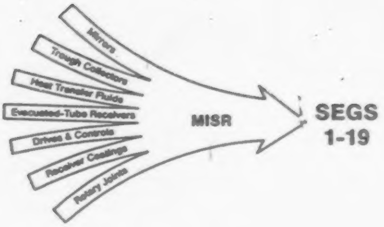


PV POWER MODULE STATUS

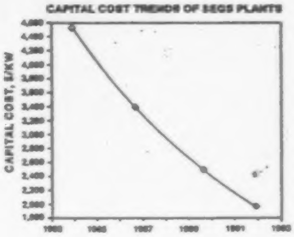

Progress in Efficiencies for Laboratory Cells
Conversion Efficiency (%)
0
5
10
15
20
25
30
35
1978
1980
1982
1984
1986
1988
31%
High Efficiency Concentrator Cells
22.8%
Flat Plate Single Crystal Silicon Cells
14.6%
Flat Plate Thin Films

SOLAR THERMAL RESEARCH & DEVELOPMENT

As illustrated below, innovations in materials and components for parabolic troughs were integrated into and proven by the DOE Modular Industrial Solar Retrofit (MISR) systems. These enabling technologies encouraged Luz to employ these component improvements in its commercial systems. As innovations were incorporated into successive commercial systems, each new generation reflected lower system capital costs and lower energy production costs as illustrated. Luz is now considering further reductions in cost by replacing hybrid solar/gas steam generators with storage systems currently under development by DOE. Specific feedback of this kind is incorporated into the DOE research and development program and strengthens industry's ability to continue deployment of systems in broader applications with increased user confidence.



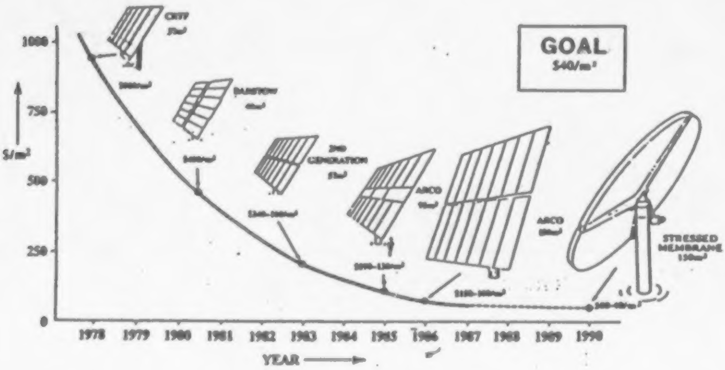
Commercial Solar Thermal Systems



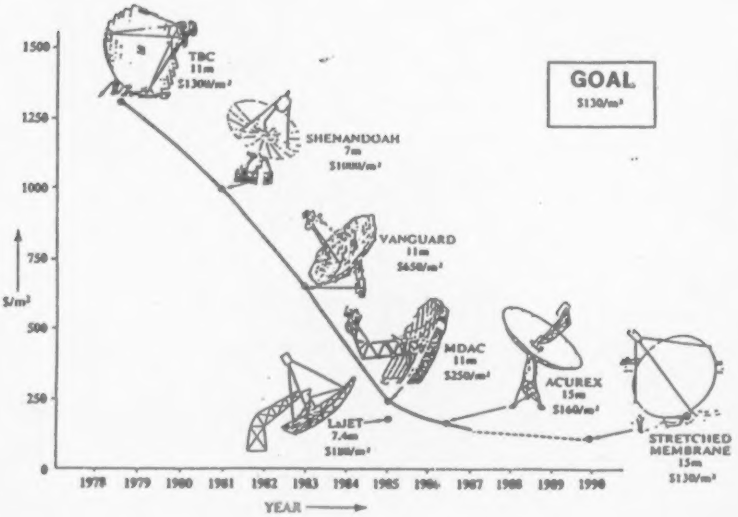
Such processes, in the longer term, also allow solar thermal systems to enter advanced applications such as hazardous waste destruction, materials processing and fuels and chemicals processing. While prototype solar thermal systems have not been tested in these applications, industrial manufacturers of concentrators have begun to see how the low-cost membrane dish concentrators and central receiver technology can directly be used to conduct chemical reactions in a receiver/reactor. Laboratory data have encouraged industry to begin to develop plans and assess the market potential for integrating solar thermal systems into these emerging applications which have national importance.

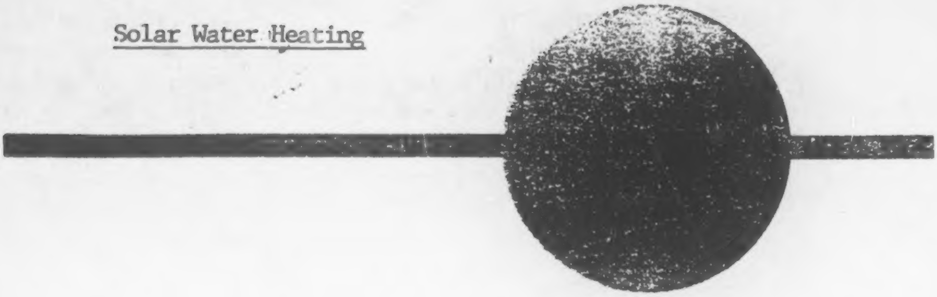
Receivers for solar thermal systems have also evolved during the past decade. Initially small-scale field experiments were needed to investigate the feasibility of using tube receivers to produce steam. In the early 1980s a scaled-up water/steam receiver was deployed in the 10-megawatt Solar One Pilot Plant, a systems experiment developed by DOE in conjunction with Southern California Edison Utility Company. Today's R&D efforts are aimed at further reducing receiver costs through the use of advanced designs and molten salts as the heat transfer fluid.

Progress In Heliostat R&D



Progress In Dish Collector R&D





ACTIVE SOLAR HEATING SYSTEMS DESIGN MANUAL

**American Society of Heating, Refrigerating,
and Air-Conditioning Engineers, Inc.**

in cooperation with

Solar Energy Industries Association

ACEC Research & Management Foundation

EXECUTIVE SUMMARY

PURPOSE

This manual was prepared to provide architects/engineers (A/Es) of large active solar heating systems with the best available design information for large commercial-scale solar service water and space heating systems. It incorporates experience from the solar industry and from government-sponsored programs that have demonstrated and advanced the technology of active solar heating systems.

The manual is not a "stand-alone" document. The manual draws on information from both industry and government sources. It requires the use of referenced documents to address basic engineering and design practices. Addition or removal of information to adapt the manual to the individual needs of the architect/engineer is left for the user to do.

The manual is to be used by the A/Es of active solar heating systems from concept development through final design. Solar insolation calculations and system configurations are included for experienced A/Es of conventional heating systems who may not have a working knowledge of solar energy systems. The manual may also be used by a prospective owner to follow the progress of solar energy system design, from concept through final design. After the system is built, the manual's design package will provide a record of how and why certain design decisions were made, for reference during future repair or modification.

Finally, the manual provides information for preparation of system installation, operation and maintenance procedures. The companion volume to this design manual, Installation, Operation and Maintenance (IOM) Manual, should be used during preparation of the IOM procedures for the as-built solar energy system.

SCOPE

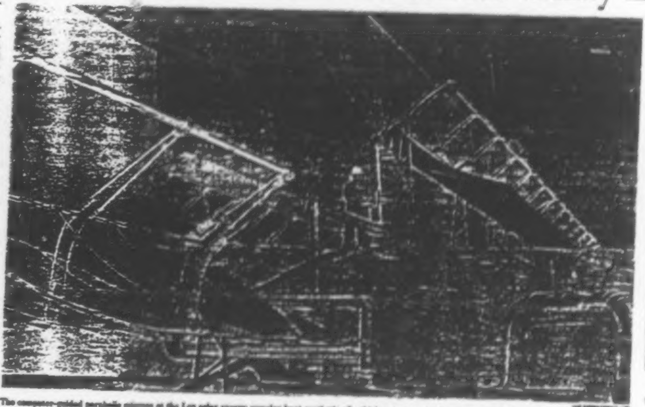
The manual is for use in designing commercial and industrial solar energy systems for service water heating and space heating. The systems described in this manual have been demonstrated to be dependable and efficient to operate. The systems are limited to those using flat plate or evacuated tube collectors, liquid or air cooled, and requiring solar storage of at least 1000 gal (3,800 L) of water or equivalent or a collector field of at least 700 ft^2 (65 m^2). The systems' highest operating temperature is that temperature recommended by the collector manufacturer.

Solar Thermal Power

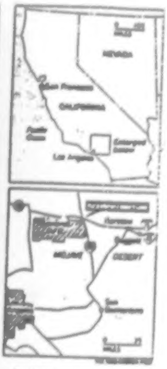
The Washington Post ... Thursday, March 2, 1989 A25

Solar-Energy Complex Hailed as Beacon for Utility Innovation

By Jay Mathews
Washington Post Staff Writer



The computer-guided parabolic mirrors at the Luz solar energy complex heat synthetic oil, which warms water to produce steam that runs an electric turbine.



KRAMER JUNCTION, Calif.—Almost no one noticed in 1984 when a few American and Israeli engineers opened a small solar-energy plant near this ramshackle crossroads in the Mojave Desert. Their effort was written off as another utopian venture certain to fail, and the group's next six solar plants also attracted little attention.

Now, however, as the turbines hum with 194 megawatts of power drawn from spreading ranks of trough-like parabolic mirrors and the company begins an unprecedented $1.2 billion expansion, major U.S. utility executives and World Bank economists are starting to hail the enterprise as an international phenomenon.

The Luz International Ltd. complex has become, with almost no notice, the largest solar-power facility ever built and the source of an estimated 90 percent of the world's electricity drawn from the sun's radiation.

At a time when some scientists are predicting economic and environmental catastrophe from the "greenhouse effect" caused in part by oil- and coal-fueled power plants, policymakers are thinking again about solar power and scrambling for information about Luz's rapid growth and technological innovation.

"We believe that they are far and away on the leading edge of this technology," said John McConomy, vice president of Potomac Capital Investment Corp., which owns a large share of the project as a subsidiary of Potomac Electric Power Co. in Washington.

"That is the world's most advanced effort to bring solar energy into large-scale production," said Scott Sklar, executive director of the Solar Energy Industries Association. He and other experts said the project shows that solar power can become a vital supplement to more traditional energy sources, particularly during peak daytime hours in hot, dry climates.

"We are seeing one company get a jump on an explosion," said Chris Jensen, a chemical engineer who came to work for Luz two years ago. "Anyone who thinks oil prices are going to stay down is naive. When they go up again, everybody is going to start talking feverishly about solar, and we'll already be there."

Buttressed in its early years by federal and state tax incentives, favorable regulatory rules, a lucrative local power contract and the reputation of inventor Arnold Goldman, one of its founders, Luz employs 700 people in California and Israel and recorded $155 million in revenue last year.

Although the tax incentives are almost gone in an era of budget deficits and cheap oil, a change in federal regulations has allowed the company to build five larger plants capable of tripling its generating capacity to almost 600 megawatts, enough for the residential needs of a city slightly bigger than Washington.

Robert San Martin, deputy assistant secretary for renewable energy at the Department of Energy, said he was particularly impressed by Luz's skill in finding a large market for its product. "It's very clear that they have been a substantial success story," he said.

Company officials and investors said the new plants' larger size and several technical improvements would decrease the crucial cost of solar power to about eight cents per kilowatt hour. That is less than the cost of power from new nuclear plants and closer to the average cost of electricity, about six cents per kilowatt hour, than solar-power engineers have ever achieved.

At the same time, company officials and the Solar Energy Industries Association, based in Arlington, Va., are calling for a reversal of declining government support of research and development of both solar-thermal energy and other major solar technologies, particularly the direct sunlight-to-electricity conversion called photovoltaics, which runs solar-powered watches and calculators.

Both solar thermal and photovoltaics, the association said in two reports last November, can with government assistance strengthen "the U.S. competitive edge, provide reliable domestic energy, lower environmental degradation, strengthen national security, lessen Third World debt and aid the U.S. balance of trade."

Luz was founded in 1979 by Goldman, an American engineer with a reputation as a dreamy visionary and clever businessman, and Patrick François, a French financier. They named the company Luz after the biblical site of Jacob's ladder, the place where the Hebrew patriarch dreamed of angels moving between heaven and Earth. Luz also is the Spanish word for light.

Goldman's reputation as the man who designed one of the first word processors and who sold his successful Lexitron Corp. to Raytheon helped win initial backing for his solar-energy scheme.

The company began research and development in Israel, where Goldman and François also have citizenship. In a telephone interview from Jerusalem, Goldman noted that basic solar-thermal technology is "quite old" but that research at places such as Sandia National Laboratory in New Mexico and his own experiments gave it "an efficiency that it had never attained before."

The Luz method uses long troughs of curved mirrors, guided by computers, to heat synthetic oil passing through vacuum-sealed tubes to 735 degrees Fahrenheit. The oil in turn heats water to produce steam and run an electric turbine.

They set up the first small, 14-megawatt plant in Daggett, 30 miles east of here, added a second, then built their third through seventh plants in this tiny road stop about 140 miles northeast of Los Angeles near Edwards Air Force Base. Kramer Junction comprises little more than a few gasoline stations and some roadside eateries such as "The Astro Burger," but its light blue desert sky offers what assistant general counsel Paul Savoldelli calls "clean sun," a dependable source of solar radiation usually unstained by smog, clouds or rain.

Southern California Edison Co., which buys Luz-generated power, is required by federal law to purchase electricity from qualified small suppliers. But the huge utility, impressed by Luz's performance, has given the solar company stable and profitable 30-year power contracts.

On hot summer afternoons when demand from millions of Los Angeles air conditioners peaks, the sun beating down on Kramer Junction generates maximum solar power. "It's almost poetic, it's such a perfect match between solar and what Edison wants," Jensen said.

In the winter, when the sun's rays are weaker or when Edison needs extra power at night, such as during California's recent cold snap, Luz uses a small natural-gas boiler to supplement or replace solar power. The plants qualify for exemption from expensive federal paperwork requirements if no more than 25 percent of their power each year comes from such nonrenewable sources as gas.

Luz is negotiating new contracts with San Diego Gas and Electric and exploring sites for plants in Arizona, New Mexico, Brazil and India. Company officials contend that their power costs would look even cheaper if governments compared the costs not only of building a coal or nuclear plant but also of digging up fragile landscape for more coal or uranium and polluting the air and water.

Building a solar plant, Luz executives note, also is much quicker, requiring as few as 18 months after contract signing, compared with five to 10 years for many fossil- and nuclear-fuel plants.

Workers who arrived at Kramer Junction when little more than sagebrush dotted the landscape shake their heads at the new office building, the acres of mirrors and the intricate maze of heat-transfer pipes spreading over the desert. Jensen smiles and points to three thick cables supported by wooden poles running past The Astro Burger toward the unseen cities to the south.

Several Luz executives and investors recently addressed a Washington audience at the invitation of the World Bank, a welcome sign of acceptance to many workers here. "They used to say, 'You'll never do it,'" Jensen said. "Now they say, 'You did it. We're interested.'"

STATEMENT OF SHEET METAL WORKERS' INTERNATIONAL ASSOCIATION, AFL-CIO, SUBMITTED BY EDWARD J. CARLOUGH

As Co-chairman of the Sheet Metal Workers' National Pension Fund which has assets of over $1 billion and as General President of Sheet Metal Workers' International Association, AFL-CIO with over 160,000 workers and some 10,000 contractors nationally, I urge you to extend the Solar Business Tax Credit for a minimum of 3 years.

The commercialization of solar energy technologies in particular, the photovoltaic technology is of great interest to the Sheet Metal and Air Conditioning Industry. Traditionally, we have provided the management and technical expertise to fabricate, install and maintain heating, ventilating and air conditioning systems.

As a result of the energy crises of the 70's and the subsequent recession, we contracted for independent studies by the Stanford Research Institute, Syracuse University, and the Mitre Corporation to assess new sources of jobs in the energy field through the year 2000. These studies recommended that we give a priority to preparing for the commercialization of solar energy technologies and that we take appropriate actions to encourage their commercialization.

With this information in hand, our Industry has undertaken several very important activities.

1. We developed curricula to train our Industry's instructors, technicians, and contractors to fabricate, install and maintain solar-thermal energy systems.
2. We equipped our training labs which are located throughout the U.S. with solar training materials and equipment.
3. We installed a solar-thermal system on at least one of our training facilities in each region of the country.
4. Three years ago we constructed in Alexandria, VA a major office complex to house the Sheet Metal Workers' National Pension Fund and our other trust funds. Integrated in the design and construction of this building was a solar-thermal energy system that provides 100 percent of the space and water heating needs and a significant portion of the air conditioning needs. The system uses the advanced evacuated tube collector, and it is the largest one funded entirely with private funds.
5. Most recently, via our National Pension Fund, we invested over $15 million in the Chronar Corporation of Princeton, NJ. Chronar is a publicly held company, and it is the world's largest and lowest-cost producer of photovoltaic panels and products. This technology represents the high-tech side of the solar technologies. Photovoltaic panels convert light electrically into AC electricity
6. In addition to our investment in Chronar at the corporate level, the Sheet Metal National Pension Fund is the lead investor along with Chronar, Pacific Gas and Electric Enterprises and Bechtel Development Corporation in a partnership to construct the world's largest photovoltaic panel manufacturing facility. It will be located in Fairfield, CA and will be in operation in 1990.

The panels which will be produced at the Chronar California facility will enable Chronar to enter new markets with competitively priced systems. These markets are 1.) large-scale residential, commercial and industrial facilities; and 2.) electrical power generation stations. These will not be easy markets to penetrate given current market forces and the inherent problems of competing against proven systems.

The solar technologies and especially photovoltaics are being commercialized against the greatest of odds including the absence of a comprehensive national energy policy and an adequately funded federal research and development program. Surely, it is in our national interest not to loose this photovoltaic technology to foreign competition. It has the potential to meet world-power needs on a very substantial scale; reduce the severity of environmental degradation from fossil and nuclear fuels; and generate a continuous source of high-paying jobs for American workers.

The Sheet Metal Workers' National Pension Fund, the International Brotherhood of Electrical Workers' National Pension Fund, Pacific Gas & Electric Enterprises, Bechtel Development Corporation, and Harbert Capital Services are working with Chronar to bring photovoltaic products and systems to market as quickly as possible. We believe it is a model example of private enterprise and labor working together.

However we need for the near-term a stronger hand from the government to assist in opening the door on primary markets for photovoltaic systems. The extension of the Solar Business Tax Credit for a minimum of 3 years will greatly enhance the certainty and fairness of the market environments in which the photovoltaic industry must compete. I urge you to extend the Solar Business Tax Credit for a minimum of 3 years. Thank you.

News Release—

SHEET METAL WORKERS' NATIONAL PENSION FUND ENTERS AGREEMENT WITH CHRONAR CORP. FOR A $13 MILLION SEMI-AUTOMATED AMORPHOUS SILICON PHOTOVOLTAIC MANUFACTURING PLANT

Princeton, N.J., January 7, 1988—Chronar Corp. (NASDAQ:CRNR) today announced that it has entered into definitive agreements with the Sheet Metal Workers' National Pension Fund to establish a $13 million 10-megawatt semi-automated photovoltaic panel manufacturing plant. Photovoltaic (PV) panels are solar devices that convert light energy directly into electricity.

Pursuant to the agreements, the Company has received a down payment of $3.5 million from the Pension Fund. The balance of $9.5 million will be paid to Chronar in several installments.

The Pension Fund will lease or acquire a suitable site which Chronar is responsible for identifying. In addition to the $13 million turnkey package, it is anticipated that the project will require up to an additional $6 million in financing for general working capital purposes. Chronar is responsible for obtaining these funds, which will be secured by the Pension Fund's pledge of the equipment.

Chronar will manage the facility and market its products pursuant to a 10-year management and services agreement. This agreement provides that Chronar will receive an annual $150,000 management fee payable from positive cash flow and reimbursement of its management expenses payable from revenues and working capital financing. As owner of the plant, the Pension Fund will receive a priority amount of the venture's net income. After this amount, the venture and Chronar will evenly divide remaining net income. Chronar will receive its usual 5% technology royalty as part of its share of profits. Chronar has agreed that the plant will commence operation not later than April 1989, and will run on not less than a one-shift basis throughout the term of the agreement.

Chronar is now in the final stages of selecting a site for the plant and is in discussions with various states and municipalities to determine a suitable location. Further, Chronar, with the Pension Fund's support, is seeking participation in the project by an electric utility. Chronar expects to complete site selection and the choice of a possible utility partner by March 1988.

This is the first of a new generation of semi-automated PV panel manufacturing plants designated by the Company as "Eureka" plants. Pursuant to a separate agreement, the Pension Fund will receive a payment from Chronar of 6% of the proceeds of each sale to third parties of subsequent Eureka plants or interest therein and 6% of the cost allocatable to Chronar's interest in each Chronar-owned or affiliated Eureka facility. The Pension Fund, or its designees, have agreed to perform certain consulting services in exchange for these fees. Further, the Pension Fund will be entitled but not obligated to purchase each fully automated flow line plant to be located in the United States or Canada or up to 50% of Chronar's equity in each flow line plant sold to a third party or constructed for its own use for a period of five years from the time of the first such sale. In the event that the Pension Fund does purchase a future flow line plant, Chronar will accept as part payment the Eureka equipment at its then depreciated book value.

The first Eureka facility will have a 10-megawatt capacity, eight times as large as any other of Chronar's existing amorphous silicon PV plants. The company believes that direct manufacturing costs of the Eureka facility will be substantially lower than at its existing batch plants, which Chronar believes already have the lowest production costs of any PV manufacturer. The plant will be larger then any other amorphous silicon PV manufacturing facility existing today.

Upon full operation, the plant is expected to have the capacity to produce about 2 million square feet of PV panels. It is expected that most of the output of the facility—panels 2.5 feet by 5 feet in size, a larger size than at the other Chronar facilities—will be used for power generation by electric utilities, for industrial applications and for power projects in developing countries. It is anticipated that members of the Sheet Metal Workers International Association will be active in installing the panels in some of these applications.

Chronar also announced that its French affiliate, Chronar France, has suspended negotiations to acquire an additional 30% interest in Photowatt S.A. pending a reconsideration of the original acquisition by Chronar France of a controlling 56% interest in Photowatt in July 1987.

Chronar is the largest U.S. manufacturer of amorphous silicon PV panels, and together with its subsidiaries and affiliates is currently operating one-megawatt batch plants in Port Jervis, New York; South Wales, United Kingdom; and Lens, France.

A new batch plant in Birmingham, Alabama, which Chronar manages has recently commenced preliminary operations, a batch plant in Harbin, Peoples Republic of China is nearing completion, and the Company has commenced shipment of equipment for a new batch plant in Split, Yugoslavia. Another one megawatt batch plant proposed for Shenzhen, China (near Hong Kong) is still subject to financing and government approval, both of which have been delayed. Upon full operation of the five batch plants now operating or nearing completion, Chronar will have annual PV capacity of approximately six megawatts.

News Release—

CHRONAR CORP. SIGNS AGREEMENT IN PRINCIPLE FOR JOINT VENTURE WITH UNITS OF PACIFIC G&E AND BECHTEL

Princeton, NJ., June 2, 1988—Chronar Corp. (NASDAQ:CRNR), the largest U.S. manufacturer of amorphous silicon photovoltaic solar panels, today announced that it has executed an agreement in principle under which two additional parties will participate with Chronar and a subsidiary of the Sheet Metal Workers' International Association's (AFL-CIO) National Pension Fund in a previously announced plan to build and operate an advanced photovoltaic manufacturing facility. The proposed partners are PG&E Enterprises, which is a wholly owned subsidiary of Pacific Gas and Electric Company, and Bechtel Development Company.

In the agreement, PG&E Enterprises and Bechtel Development (Bechtel) propose to form a joint venture company with Chronar and the pension fund's subsidiary to be known as the Chronar Photovoltaic Company of California. The purpose will be to build, own and operate a 10 megawatt-capacity panel production plant using Chronar's new semi-automated "Eureka" manufacturing process to produce larger-size photovoltaic panels. Photovoltaic panels convert light directly into electricity.

The agreement contemplates that the venture would be capitalized at $22 million, with $11 million in equity. PG&E Enterprises would invest $3 million, Chronar and Bechtel would invest approximately $500,000 each, and the union pension fund possibly with another party agreeable to all partners—is expected to invest the remaining $7 million. The remainder of the capital is to be in non-recourse debt of the joint venture that is expected to be arranged for by the partners.

The union pension fund, which had already agreed to buy from Chronar for $13 million the equipment and technology necessary for the plant, is expected to transfer its rights in the equipment and technology to the joint venture for the original purchase price of $13 million.

Bechtel National, Inc., under the agreement, is to be the project manager and prime contractor for the construction of the new facility, which is to be in Pacific Gas & Electric's service area in northern California. Bechtel Development Company and Bechtel National, Inc. are both units of Bechtel Group, Inc.

Chronar will operate the facility and market its output for resale worldwide under a technology, management and services agreement. PG&E Enterprises may also buy some of the output.

Chronar as part of the agreement is to grant to PG&E Enterprises and Bechtel certain rights to participate in the equity and construction roles of future Chronar manufacturing ventures and power generation projects, primarily in North America. Chronar in turn is to enjoy certain rights to supply manufacturing equipment, products and photovoltaic panels for future projects of PG&E Enterprises and Bechtel and may grant licenses to those parties.

The agreement is subject to continuing due diligence by PG&E Enterprises and Bechtel, to the consent of the union pension fund, which was not a signatory to the agreement in principle, and to execution of definitive agreements.

In a separate agreement, Chronar has granted PG&E Enterprises the right to purchase up to 250,000 restricted shares of Chronar's common stock at $7.30 per share until July 31, 1988. Each share would carry a 10-year warrant to purchase six-tenths of a share of Chronar common stock with an exercise price of $9.50 per share. Should PG&E Enterprises in fact acquire and continue to hold 250,000 shares or more of Chronar's common stock, Chronar has agreed to nominate one PG&E Enterprises representative to Chronar's Board of Directors.

Dr. Zoltan J. Kiss, chairman and chief executive officer of Chronar, said: "This proposed joint venture of PG&E Enterprises, Bechtel, the Sheet Metal Workers' National Pension Fund and Chronar is a milestone in the evolution of the photovoltaic industry. Bechtel's worldwide engineering expertise and PG&E Enterprises' status in the United States electric utility industry will be a most helpful factor in the introduction of photovoltaics in the power industry. We at Chronar are gratified by the endorsement of our technology by these leaders in the energy industry."

News Release—

PG&E ENTERPRISES PURCHASES STAKE IN CHRONAR CORP.

Princeton, New Jersey, August 3, 1988—Chronar Corp. (NASDAQ:CRNR) today announced that PG&E Enterprises (PG&EE), a wholly-owned subsidiary of Pacific Gas & Electric Company (PCG), has purchased 250,000 shares of no par common stock of Chronar Corp. for $1,825,000. The private placement was made pursuant to a right to purchase granted to PG&EE as part of a contemplated joint venture between Chronar and PG&EE and others to build and operate an advanced ten megawatt photovoltaic manufacturing facility in Northern California. The parties are presently finalizing site selection and negotiating definitive joint venture agreements which are expected to be concluded later this year. The facility is expected to commence operations in late 1989 or early 1990.

The stock purchase includes a ten year common stock purchase warrant for 150,000 shares at $9.50 per share. PG&EE has a right to nominate a representative to Chronar's Board of Directors and has designated Mason Willrich, the Chief Executive Officer of PG&EE and an Executive Vice President of Pacific Gas & Electric Company to join Chronar's Board of Directors. As a result of the purchase of shares by PG&EE, Chronar now has approximately 11,000,000 shares outstanding.

Chronar is a leader in the research, development and commercial production of amorphous silicon photovoltaic panels that convert light directly into electricity. The company develops and sells photovoltaic-panel production equipment and photovoltaic-powered consumer and industrial products, and develops and markets electricity-generating power stations using photovoltaic panels.

News Release—

CHRONAR TO SELL UP TO $22 MILLION PRIVATE PLACEMENT OF STOCK TO NATIONAL ELECTRICAL CONTRACTORS PENSION FUND

Princeton, N.J.—August 18, 1988—Chronar Corp., (NASDAQ:CRNR) the largest U.S. manufacturer of amorphous silicon photovoltaic solar panels, today announced that it has signed a letter of intent with The National Electrical Contractors Association Pension Benefit Trust Fund for a private placement of its common stock.

Chronar has agreed to sell the fund 1,428,572 of its no par common stock at $7.00 per share on or about September 30, 1988! but in no event later than October 14, 1988. The transaction is subject to completion of the fund's due diligence and execution of definitive agreements, which are expected before the end of September. Chronar presently has approximately 11 million common shares outstanding.

The total proceeds to Chronar from this private stock placement will be $10 million. The fund will not participate in a proposed 10 percent stock dividend, which has a declared shareholder record date of September 2, 1988, and is to be paid on October 3, 1988. The stock dividend is subject to shareholder approval of an increase in the authorized number of shares of common stock of the company, at a special meting of shareholders which has been called for September 30, 1988.

For each share purchased by the fund, the fund will also receive a warrant entitling it to purchase an additional share of Chronar's common stock at a price of $10 per share. Such warrants will be exercisable for a period of 10 years with an early forced exercise should the market price of Chronar's common stock reach $30 per share.

The fund will, upon completion of the initial investment, have the right to purchase, at a price per share equal to 85 percent of the market price, up to $12 million of additional common stock. The purchase may be made in up to three installments on November 30, 1988, January 31, 1989, and March 31, 1989. The market price will be the average price for 20 trading sessions preceding the relevant purchase date. For each share purchased by the fund at the time, the fund will receive six-tenths of a warrant, each full warrant entitling it to purchase an additional share of Chronar's common stock at a price equal to 130 percent of the relevant purchase price. The warrants will have a term of ten years with an early forced exercise should Chronar's common stock achieve a market value equal to three times the exercise price of the warrant.

Once the fund has made its initial investment by purchasing at least the initial 1,428,572 shares, it may make an equity or debt investment in any of Chronar's future manufacturing or power station projects in the United States. To the extent the investments are made prior to December 31, 1990, the fund will be entitled to purchase additional shares of Chronar's common stock. The fund is expected to be granted the option of investing in the company's Eureka project, presently planned with PG&E Enterprises, Bechtel Development Corp., and a subsidiary of the Sheet Metal Workers' National Pension Fund,. on terms as favorable as those presented to other investors in Eureka.

As long as the fund holds at least one million shares of Chronar's common Stock, the fund will have the right to nominate two persons to serve on the company's board of directors, one of whom will also serve on its executive committee.

Jack Moore, the Secretary of the fund, stated "Our investment in Chronar goes far beyond being simply a good financial decision. It is an investment in an industry segment which we believe will become a source of future employment for our members in a dynamic sector of the energy industry."

Zoltan Kiss, chairman of Chronar, said, "The investment in our company by the Electrical Contractors Association Pension Fund expands Chronar's opportunities and brings us a level of expertise that will help spur our growth and market share as a truly viable alternate energy producer. This fund now joins the Sheet Metal Workers National Pension Fund in a commitment by labor to reindustrialize America by supporting an important new technology here at home."

Chronar is a leader in the research, development and commercial production of amorphous silicon photovoltaic panels, which convert light directly into electricity. The company develops and sells photovoltaic-powered consumer and industrial products, and develops and markets electricity-generating stations using photovoltaic panels.

News Release—

CHRONAR CORP., UNIT OF SEAWEST POWER SYSTEMS, INC. TO JOINTLY DEVELOP ESTIMATED $125-MILLION, 50-MEGAWATT PHOTOVOLTAIC POWER STATION

Princeton, N.J., September 8, 1988—Chronar Corp. (NASDAQ:CRNR), the largest U.S. manufacturer of amorphous silicon photovoltaic (PV) solar panels, today announced the signing of an agreement with SeaWest Industries, Inc., a wholly owned subsidiary of SeaWest Power Systems, of San Diego, for the joint development of a 50-megawatt photovoltaic power station.

When developed, the PV power station is expected to be seven times larger than any already existing PV power station, and is expected to generate competitively priced peaking electricity.

The power station, which will be located in the Lancaster- Palmdale area of California, will sell electricity to Southern California Edison Company pursuant to existing Standard Offer No. 4 power purchase agreements. Such agreements pay favorable rates to suppliers of electricity that use specified renewable energy sources.

The successful development of the project will depend on the availability of construction and project financing on favorable terms and the completion of other development steps and regulatory matters. The project will be constructed after specific sales transactions are negotiated with and financing commitments are obtained by third party investors. The project may be constructed as several units depending upon how the sales transactions are ultimately structured. Chronar anticipates that certain of its present investors and partners may participate as third-party investors in the project. The ability of Chronar and SeaWest to attract such investors may be dependent on the continued availability of tax benefits, some of which are now scheduled to expire at the end of 1988.

Chronar anticipates selling the completed photovoltaic power station to third party investors at an estimated installed price of $2,500 per kilowatt of capacity, or $125 million for the entire 50-megawatt development. The actual installed price of any portion of the project will be affected by then-existing tax laws, interest rates, negotiations with investors and lenders, and other considerations. Construction of the project is expected to begin in late 1989 and to be completed in 1992.

The project will use PV modules to be manufactured at Chronar's recently announced 10-megawatt-per-year manufacturing facility to be built in California. To supply additional modules for this project, Chronar anticipates building additional 10-megawatt-capacity manufacturing plants.

The agreement between Chronar and SeaWest provides for a sharing of the responsibilities, benefits and risks of developing the power station. To make development of the project possible, Chronar has agreed to expend $1.61 million over the next nine months for site acquisition, preparation and other development expenses.

Dr. Zoltan Kiss, chairman and chief executive officer of Chronar, said: "The development of this 50-megawatt PV power station will be by far the single most important event in the history of the photovoltaic industry. It will conclusively demonstrate the viability of photovoltaics as a reliable, cost effective, safe and clean source of electricity." He noted that "the broad development of solar energy is necessary to combat the adverse environmental considerations of burning fossil fuels, such as the greenhouse effect and acid rain". Dr. Kiss also said that "the company will continue to aggressively pursue additional manufacturing capacity and PV power station opportunities in the United States and abroad."

SeaWest is the third-largest developer of wind farms, with the highest capacity factor in 1985, 1986 and 1987 among the 10 largest developers of wind turbine generators, according to the California Energy Commission. To date, it has successfully developed 22 projects with an installed capacity of 160 megawatts, requiring over $200 million in capital. SeaWest, which has been in the development business for seven years, has extensive experience in preparing renewable energy sites for development. SeaWest and Chronar will work closely together on the various aspects of the PV power station project.

Charles Davenport, chairman and chief executive officer of SeaWest, said: "Photovoltaics is a promising new energy source with widespread domestic and international applications. SeaWest views this joint development of 50 megawatts as a major event in the realization of cost-effective photovoltaic grid electricity production through mass production and installation."

Mr. Davenport also added: "SeaWest's expansion into photovoltaics is a natural development into a compatible technology, with similar financial and marketing structure. SeaWest's expansion into photovoltaics is part of a plan to develop integrated renewable energy power systems such as wind, photovoltaic and hydroelectricity for utility grid interconnection."

Chronar is a leader in the research, development and commercial production of amorphous silicon photovoltaic panels, which convert light directly into electricity. Chronar develops and sells photovoltaic powered consumer and industrial products, and develops and markets electricity generating stations using photovoltaic panels.

Forbes
DEC 12 1988

Is widespread use of solar energy just a slender, distant hope? Not if one can believe Zoltan Kiss. Chronar's founder says solar is getting closer to competing with fossil fuels for generating electricity.

Solar energy—getting hotter

By James Cook

ZOLTAN I. KISS is close to cashing in on a decade of breathtakingly hard work. A volatile and voluble man. Kiss is chairman of Lawrenceville, N.J.'s Chronar Corp. In Chronar, Kiss has put together the U.S.' largest and most successful producer of amorphous silicon photovoltaic cells, those 1-by-3-foot panels that spontaneously transform light into electricity, and that for Chronar seem at last about to pay off.

Mail-order-catalog buffs are already familiar with at least one Chronar product, those solar-powered garden lights that require no wiring. But these are just frills. Chronar is into far more important stuff. Like winning a fair share of the world's future electricity market.

"To develop the technology for amorphous silicon," Kiss says, "we had to identify the manufacturing process, then build the equipment, because it didn't exist. Then raise the money and set up the factories. You couldn't have a product until you had the panels to put into product. One step after another. It took us a decade of incubation to get that far."

Photovoltaics long ago proved themselves in space, but costs were so high their commercial development has been slow in coming. All that is changing, thanks to the development of microscopically thin, amorphous noncrystalline coatings on glass, steel, aluminum or plastics, which cut production costs dramatically. With its costs continuing to decline, solar energy shapes up as the most benign answer to the world's growing energy and environmental problems.

There are other players in the photovoltaic business—Arco Solar, Energy Conversion Devices and Amoco's Solarex division, among others—but Chronar has gone further in bringing photovoltaics to the point of commercial development than any of its competitors. Either directly or through joint ventures abroad, Chronar can now manufacture 10,000 kilowatts of generating capacity a year and should have twice that next year.

Chronar's Kiss and a working photovoltaic panel
From walkway lights to power stations.

Ten thousand kilowatts may not seem like much considering that the average new conventional power station runs around 600,000 kilowatts these days, but then Edison's original Pearl Street generating station started with only 360 kilowatts of capacity.

For Chronar, the explosion has already begun. Having diddled around at under $1 million in annual sales for nearly a decade, Chronar booked $11 million in 1986, $17 million in 1987, and should wind up with some $35 million this year and $70 million or more in 1989. "We're at the place where the company's sales are doubling," Kiss says, "and I think the doubling will continue at least for the next three or four years." That's a tall order. Keeping that up would make Chronar a half-billion-dollar-a-year company within a very few years.

Part of Chronar's growth has come from sales to affiliates of equipment for manufacturing solar panels. But Chronar is manufacturing more and more end products: Besides the walkway and garden lights for the consumer market, there are billboard lights, highway lighting and water pumps for industrial markets, especially in areas beyond the reach of conventional power sources. Last year Chronar sold only $4 million worth of consumer products. This year it will sell about $13 million. Last year it sold no industrial products. This year it will sell over $1 million. Next year, depending on the rate of market development, it should sell $10 million or more.

Best of all, after piling up more than $20 million in losses in the past five years, Chronar will probably break even this year though nine-month earnings were still $1.1 million in the red. "For ten years we were in the development stage," Kiss says. "We are now at the point of turning into the black, and from now on we expect to be profitable."

A physicist by training, Kiss left his native Hungary in 1950 at the age of 17, picked up a Ph.D. at the University of Toronto, and wound up in the early 1960s as head of quantum electronics research at RCA Laboratories in Princeton, N.J. He quit RCA Labs in 1969 to start a liquid crystal display outfit called Optel, quit again in 1976 when Mitsubishi gained control of the company. He went out on his own, choosing photovoltaic technology and putting up $40,000 of his own money to found Chronar in 1976.

Half the battle has been finding the money to finance the losses inevitable in any high-tech development business, and it didn't help any that a few years ago the SEC went after Chronar and its accountants for what it considered fraudulent accounting practices. That stalled Chronar for a time, forcing the cancellation of a $12 million public stock offering. Kiss eased his financial problems by setting up joint-venture manufacturing partnerships around the world and in the last year or two has picked up a handful of well-heeled backers. These include Birmingham construction tycoons John and Bill Harbert (who made a $5 million equity investment), the Sheet Metal Workers' pension fund ($7.5 million in equity, $7.5 million in loans), the National Electrical Contractors pension fund ($10 million in equity) and most recently Pacific Gas & Electric ($1.8 million).

Chronar can already compete, Kiss claims, with small-scale diesel generators ranging up to 50 kilowatts, producing electricity for 25 to 35 cents per kilowatt-hour, versus 30 to 50 cents for the diesels, depending on their size and other factors. And that, says Kiss, opens up a $5 billion market. But the really big market is yet to be conquered—the one served by large-scale coal- or nuclear-fueled systems, which retail power at under 7 cents a kilowatt-hour. If photovoltaics can crack that, the potential is incalculable but surely vast. To judge by the huge short interest in Chronar's stock, not everyone agrees.

"For ten years we were in the development stage," Kiss says. "We are now at the point of turning into the black."

As Kiss likes to point out, photovoltaics is a modular technology. To increase capacity, you don't build larger plants, you just keep adding panels and interconnecting them. You don't have to hook into the utility grid. Photovoltaics can operate independently and effectively on their own. Chronar itself is putting a 60-kilowatt station on the roof of its New Jersey headquarters, which will generate power for about 20 cents a kilowatt, comparable to the 19 cents the local utility, Public Service Electric & Gas, charges at its summer peaks.

To crack the big-scale utility market, Chronar will have to do a lot better than that. The principal cost in photovoltaic power generation is the cost of the capital needed to produce and install the photovoltaic panels, and though Chronar has reduced such costs by a third in the past 18 months, it's far from enough. Chronar has recently worked out a $25 million joint venture with Bechtel, a Pacific Gas & Electric subsidiary and a Sheet Metal Workers' pension fund subsidiary to build an automated manufacturing plant, slated to go into operation next year, that is expected to cut the direct cost of manufacture by 50%. At that level, Chronar can install a power station for $2,500 a kilowatt and make a decent profit. Says Kiss: "We will have brought the cost of manufacturing down to the point where we can generate electricity in the 10-to-12-cents-a-kilowatt-hour range." That's still not enough: The utility industry generates power at a fully loaded average cost of approximately 6 cents per kilowatt-hour.

Nevertheless, Kiss is so confident that the economics of the new plant will prove out that he is working out another joint venture with SeaWest Industries, a California wind power company, to build a proposed $125 million, 50,000-kilowatt photovoltaic plant that will sell power to Southern California Edison during peak periods. Under legislation designed to encourage the use of alternative energy sources, the rates will range up to 11 cents a kilowatt-hour in 1989 and up to 24 cents in the year 2000.

At such prices, Chronar begins to move in on its utility targets, and Kiss is confident that within five years he'll be able to reduce costs another 50% by doubling the efficiency of the photovoltaic panel. If he succeeds—and that may not be so easily done as he claims—Chronar will be able to generate power for under 7 cents a kilowatt-hour, and the long-awaited breakthrough will be achieved.

It may not happen, but neither is it implausible. San Francisco's Pacific Gas & Electric is persuaded enough that it bought a 250,000-share stake in the company. "If solar panels make the economic breakthrough necessary for them to become marketable," says Richard Clarke, chairman of the big utility, "I want PG&E people installing them for our customers."

Clarke says "if," but for Kiss there are no "ifs." He foresees the day when photovoltaics will be used in the electrolysis of water to produce cheap hydrogen for fuel cells and combustion engines, opening up to photovoltaics not just the market for electricity but also the transportation market. Eat your heart out, OPEC.

Kiss becomes almost lyrical when talking of the future. Says he: "I believe photovoltaics will ultimately be the world's primary energy source, and it's just a question of how rapidly the cost can be brought down." ■

The New York Times
FRIDAY, SEPTEMBER 9, 1988

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Business Day

Chronar Plans Solar Power Plant in West

By MATTHEW L. WALD

In a landmark in the development of solar power, a company that currently makes patio lights powered by the sun said yesterday that it would build a $125 million plant in the desert near Los Angeles to make large amounts of electricity directly from sunlight.

The power would be sold at a profit to the Southern California Edison Company, under a rate established several years ago to encourage production of energy from renewable sources.

The Chronar Corporation of Princeton, N.J., said its plant would be seven times larger than any existing power station of its type, which is called photovoltaic. The plant will be built in partnership with a San Diego company, Seawest Industries.

50 Megawatts of Power Planned

The Chronar plant is expected to produce 50 megawatts, or 50,000 kilowatts, of power at peak capacity. That would provide enough power for typical use in 25,000 homes. A large coal plant produces about 600 megawatts, a nuclear plant about 1,000 megawatts.

The plant will be built in the Lancaster-Palmdale area, about 60 miles east of Los Angeles.

Other small plants are already in service that use sunlight to boil water, with the steam used to produce eletricity.

"This would be a substantial milestone," said Edward S. Sabisky of the Solar Energy Research Institute, which is financed by the Department of Energy.

Mr. Sabisky said that Chronar's announcement was only the latest in a rapid series of developments this year in the solar field, in which Chronar and two other companies have each announced plans to build large new manufacuturing plants to make additional cells.

An Energy Department spokesman, Roger Meyer, said new mass production of the solar cells had apparently permitted an important reduction in cost, which he described as a "breakthrough." He added, how-

Continued

A $125 Million Solar Plant Is Planned for California

Continued From First Business Page

ever, that the technology to be used was not new, nor was it the most advanced available.

Chronar's cells, of a type called amorphous silicon, can convert only 5 to 6 percent of the sun's energy to electricity; a company called Energy Conversion Devices of Troy, Mich., has developed cells consisting of several layers that has an efficiency of 13.7 percent and has succeeded in licensing its technology for use abroad for $15 million.

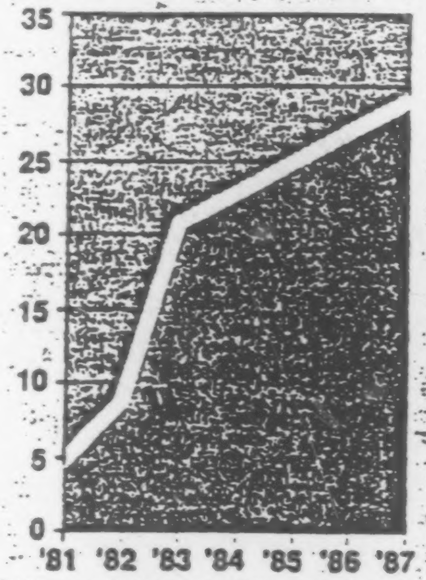
But its cost per watt of capacity is higher than the figure estimated by Chronar for its new plant.

"Photovoltaics are everybody's dream answer to energy needs," said Chronar's founder and chariman, Zoltan J. Kiss, in a telephone interview. "The problem was, it was always too costly."

Until now, the cost of photovoltaic cells has been considered too high to compete with conventional energy sources like coal and oil. Many companies have found a niche by providing power sources for locations cut off from the power grid. Chronar, the only domestic manufacturer now operating profitably, has found success in patio and walkway lights, which use the sun to charge a battery during the day and then switch on at dusk. In June, the company shipped 100,000 such lights under its own brand name, Mr. Sabisky said.

Solar's Growth

Worldwide shipments of cells that make electricity directly from sunlight. Total capacity, in thousands of kilowatts.



Source: Solar Energy Research Institute

While the Chronar plant would dwarf other photovoltaic facilities, another company, Luz International Ltd., has four 30-megawatt plants already on line.

Luz sells power to Southern California Edison under the same kind of contract that Chronar will use, under a structure established in the early 1980's to encourage alternative energy sources. According to R. Dean Gallagher, senior project development manager for Southern California Edison, the structure set the price to be paid by the utility at relatively generous levels.

With the collapse of oil prices in 1986 and other developments, he said, "at this point in time, it's very uneconomical for our ratepayers."

WALL STREET JOURNAL
Friday, November 25, 1988

CHRONAR

Chronar's Chairman Placing Two Big Bets On His Vision of a Solar-Powered Future

By RICHARD KOENIG
Staff Reporter of THE WALL STREET JOURNAL

PRINCETON, N.J.—Zoltan Kiss still keeps a sketch given him by jesting colleagues when he left a job as a research physicist. Entitled "Zoltan's Last Supper," it shows robed figures around a table, with one muttering to himself, "Hallelujah, we won't have to hear that dreaded word 'breakthrough' again."

"Oh Lord," the caricatured Mr. Kiss prays, "deliver me from these imbeciles."

Mr. Kiss, the founder, chairman and chief executive officer of Chronar Corp., has spent much of his adult life trying to persuade a skeptical world to believe in technological innovations, from lasers to the liquid crystal displays in watches. His current sermon: the potential of solar energy.

Panel-Making Plant

Mr. Kiss (pronounced Kish) sees a future where photovoltaic panels, the window-shaped cells that soak up light and send out electric current, bedeck the roofs of whole neighborhoods and stretch across open land in vast arrays. Toward that end, Chronar plans to build one of the world's largest panel-production plants next year. What's more, the company hopes to construct the world's largest photovoltaic generating station by sometime in 1992.

"Zoltan is obviously trying to push the technology extremely fast," says David Carlson, an executive at Amoco Corp.'s solar-energy subsidiary. "He's really sticking his neck out."

Though the history of solar energy is strewn with great expectations gone bust, photovoltaic technology in recent years has gained more commercial uses, in devices such as calculators and battery chargers. But the market for large-scale power generation—the potential Comstock Lode for photovoltaics companies—has barely been tapped. And that is where Chronar is heading.

The significance the company attaches to its new panel plant, to be built in the northern California town of Fairfield, is reflected in its name—the Eureka plant. Chronar bills it as the sort of automated production line needed to slash costs and thus help make photovoltaic technology more competitive with fossil and nuclear fuels. Although the plant's panels could be put to a variety of uses, the company hopes many will wind up in solar generating stations.

The generating station that Chronar envisions, which would sprawl over 500 desert acres outside Los Angeles, is meant to show that such plants are commercially feasible. The company hopes to sell the electricity to a utility during periods of peak demand.

Chronar, which had a loss of $1.1 million for this year's first nine months on revenue of $26.8 million, may seem an unlikely company to express such audacious intentions. Founded in 1975, it is a midget in a field that includes Amoco and Atlantic Richfield Co. But the 56-year-old Mr. Kiss, who left the laboratories of RCA Corp. for the up-and-down fortunes of a scientist-entrepreneur, rejects any notion that Chronar can't deliver. "We don't build card castles," he says.

Indeed, he has traveled the world doing deals in which Chronar provides equipment and knowledge to build panel-production plants. There are now six—in Port Jervis, N.Y., and Birmingham, Ala., and in Britain, France, Yugoslavia and China—though Chronar holds only minority stakes in five of the plants.

And Mr. Kiss has been raising cash and winning allies by selling stakes in the company. Two partners in the Eureka plant are also shareholders: a subsidiary of Pacific Gas & Electric Co. and the pension fund of the Sheet Metal Workers' International Association. (For the union, panel installation promises jobs.)

Promise has never been lacking since scientists began to harness the "photovoltaic effect": Light energy excites electrons in semiconductors, such as the silicon typically used in panels; the current thus set in motion is then channeled into circuitry by "doping" the silicon with chemicals that establish an electric field.

The drawback of solar energy is cost. Over the past decade, prices of photovoltaic panels, in constant 1987 dollars, have dropped to about $5 a watt from $50. But to make a dent in the utility market, many energy specialists say, prices would have to plunge to $1.

Like many other plants, the Eureka facility will use so-called amorphous silicon technology, which gives up some efficiency in capturing solar energy for lower production costs. What will set the Eureka plant apart from earlier Chronar projects is automation: Conveyor belts instead of people will move the panels among chambers where silicon and other substances are deposited onto glass backings. Mr. Kiss estimates this will cut production costs in half.

The plant, scheduled for completion in the second half of next year, would also represent a huge increase in panel-production capacity. Expected to occupy 75,000 square feet and cost $22 million, it would be capable of annual production of panels with total power of 10 megawatts. That is about one-quarter of panel production world-wide today.

The generating station, too, would represent a leap in scale. It is to be rated at 50 megawatts, or the equivalent of power used by a community of 15,000 to 25,000 people. That's more than seven times bigger than the largest existing photovoltaic generator, a project of Atlantic Richfield's Arco Solar Inc.

Can Chronar pull it off?

Not only Mr. Kiss but other photovoltaics specialists believe solar technology eventually will gain more applications in the utility market. Whether progress can keep pace with Mr. Kiss's goal of starting up the plant by 1992 is the question.

Mr. Kiss's projections of the panels' costs are in line with some estimates of what it will take for photovoltaics to compete against the price some utilities pay others for electricity during periods of peak demand—and against the cost of adding conventional generating capacity. Yet those estimates often assume that the panels will convert at least 10% of solar energy to electrical energy. The initial panels from the Eureka plant are expected to have a conversion rate of about 5%.

Cutting Installation Costs

Mr. Kiss says technological advances will eventually boost conversion ratios. More important at the outset, he says, is slashing installation costs. One example: using telephone poles instead of concrete pylons to hold up the panels.

First, though, he has another selling job. Chronar has found one partner in the generating station, SeaWest Power Systems, until now mostly a developer of windmill farms. But the venture still must line up some $125 million in funding. Prospective investors may wait to see whether the station gets to charge high rates for its electricity under a state program meant to nurture renewable energy sources.

The local utility, Southern California Edison Co., is balking, since regulators who set the rates years ago assumed rising oil prices. It says those rates are now several times higher than what its additional costs would be if it simply fired up its own idle generating capacity during peak periods. The two sides are still negotiating, but the issue could yet end up before regulators or in the courts.

For all his ups and downs, Mr. Kiss is becoming a figure that others no longer ignore. The giant engineering concern of Bechtel Group Inc., for one, plans to help build the Eureka panel plant partly to keep up with solar-energy technology.

As for the generating station, it "is still a dream in Zoltan Kiss's eye," says Pat De Laquil, Bechtel's solar-energy specialist, "but not an impossible dream."

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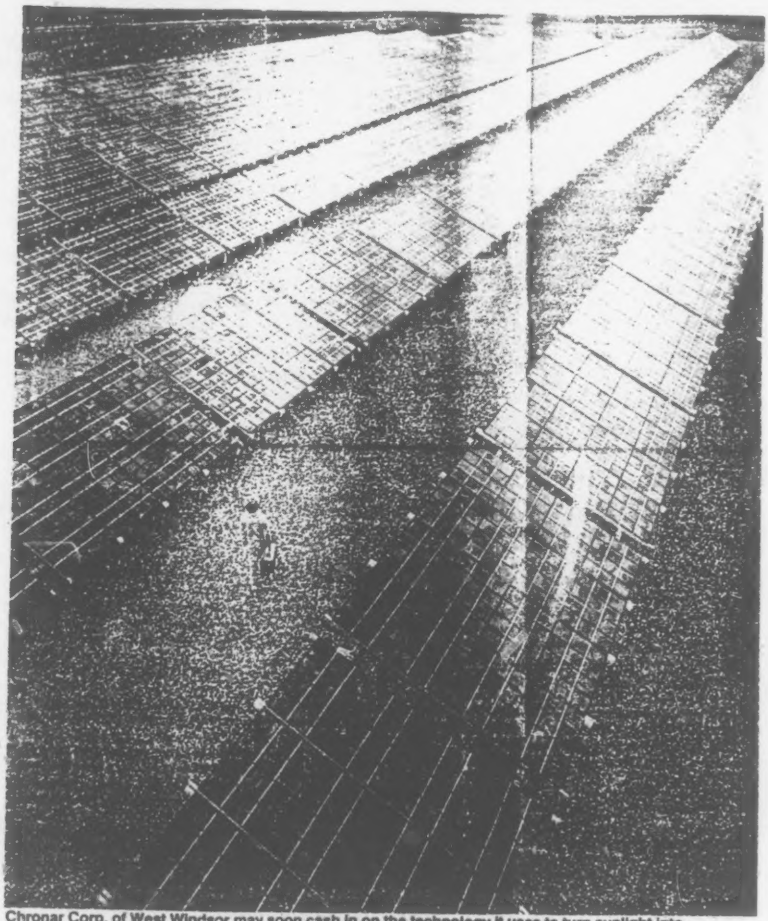
CHRONAR

Chronar on cutting edge of solar energy industry



Chronar Corp. of West Windsor may soon cash in on the technology it uses to turn sunlight into electricity. Chronar sells electricity generated in this solar panel field to the Alabama Power Co.

By JOHN RICHARDSON
Home News business writer

For many investors, Chronar Corp. is involved in a high-risk industry headed down a blind alley. But the West Windsor-based company, which develops technology to turn sunlight into electricity, is about to turn the corner, and some experts feel Chronar's future is bright indeed.

Persistence has guided the company through 12 years of net losses, and Chronar hopes its patience will soon pay off.

The company is on the verge of producing electricity cheaply enough to compete with the oil, coal and nuclear industries, through a yet-to-be built automated manufacturing plant, officials said. Becoming competitive has been the major obstacle for the high-tech, low-profile industry, and the small number of analysts who follow Chronar feel the company's name may eventually become as familiar as Exxon or Public Service Electric & Gas.

"This is going to be the world's largest industry in the next decade," said Dr. Zoltan J. Kiss, the founder and chief executive of Chronar. But, he said, "the tremendous growth potential has not yet been recognized on Wall Street."

The photovoltaic industry, he said, will control a $1 trillion market at the turn of the century, competing head-to-head with the most powerful traditional energy producers. There are now five U.S. photovoltaic manufacturers with sales totaling $300,000 million, according to industry figures.

"By the early 1990s, it will be clear that photovoltaics will be seen as a more cost effective method of generating electricity than either nuclear, coal or fossil fuels," said Kiss.

Industry experts and investment analysts agree about the approaching crossroads and the long-term potential of photovoltaics, a technology which depends on a source that will long outlast other fuel reserves. And, although the company has never turned a profit for more than one consecutive quarter, they said Chronar is in a strong position to lead the way.

Chronar now operates five manufacturing plants around the world, turning out glass panels that contain the photovoltaic cells, and three more are in the planning stage, Kiss said. The company also operates a generating plant in Alabama, which provides power to the Alabama Power Co. during peak demand periods.

200 local workers

The company employs more than 500 workers worldwide and about 200 at its headquarters in West Windsor.

And Chronar is recognized as the leader in developing a cost-effective technology, even ahead of Japanese companies which have directed their resources toward smaller scale uses like calculators, experts said.

"They seem to be on the leading edge of the technology," said Russell E. Miller, an investment analyst with Alex Brown & Son in Baltimore. But the technology is not yet ready to compete with other energy sources for a share in the utilities market, he said. "That's Chronar's big challenge — to develop the market for the (solar-to-electric) cells they're manufacturing."

The company began marketing consumer and industrial products that operated on photovoltaic principles in 1986 to create a market and provide revenues. Its most popular consumer product, a "walk light" that generates electricity, storing it during the day and lighting sidewalks and driveways at night, sells for about $50.

The consumer and industrial product sales will help Chronar achieve a net income for 1988, Kiss said. Chronar, which is traded by the National Association of Securities Dealers Quotation system (NASDQ), has reported annual net losses each year since going public in 1981. Chronar reported its largest loss, $6.88 million, in 1986, and 1987 figures have not yet been released.

The company's failure to deliver net earnings — despite several such predictions — has been cited by analysts as one reason its stock performs below the market. Chronar stock peaked at $25 dollars and bottomed at $1 in its 7 years on the market. Since the Oct. 19 crash, Chronar stock has fluctuated around $6, closing Friday at $6.25.

While Chronar is clearly a leader in terms of technology for large scale electricity production, some investors worry it may never cash in.

"I think that people will look back and say Chronar did a good job and got the industry off the ground," Smith said. "But they might say that it's another example of the brilliant scientists that, even though he had a good idea, wasn't able to make a lot of money with it."

But Smith also expects a profitable 1988 for Chronar, which can its products are marketed correctly, he said.

The company expects its new product lines to provide net earnings, but the products are only a means to an end, Kiss said.

The more important breakthrough, for Chronar and for the industry, is the company's planned automated manufacturing plant that will turn out photovoltaic panels at a cost low enough to compete with traditional energy sources.

Chronar announced last month that the Sheet Metal Worker's National Pension Fund would help finance the $20 million plant, which is scheduled to open by April, 1988 at site yet to be announced.

The plant will help Kiss meet his ultimate objective.

"Our long term goal remains what it was, to reduce the cost of photovoltaic panels to the point where it can compete in a cost effective manner with fossil fuels — oil and coal — and nuclear," he said.

Kiss' focus has taken the company from his garage to a position as perhaps world leader in photovoltaic technology.

The Hungarian-born Kiss founded Chronar in 1976, when the only application of photovoltaic technology was in the U.S. space program. Kiss, who studied physics in Toronto and England, worked with laser and early photovoltaic technology at RCA Laboratories in East Windsor.

Chronar was essentially a research operation until it built its Port Jervis, N.Y. plant in 1984, and the company did not market products until 1986. But Chronar has survived — despite cuts in federal research funding since 1981 and dwindling public support since the energy crises of the 1970s — by marketing its technology as well as its products.

The company has sold each of its manufacturing plants, while retaining some equity, to produce income. Chronar also arranged to manage the facilities for a fee, and it buys back the panels to sell again or use for its products.

By creating its own market, Kiss and Chronar have been able to persevere in their quest for large scale electricity production, a goal that soon may be within reach. "That is the ultimate area," said Kiss.

Los Angeles Times
Tuesday, March 8, 1988

CHRONAR

BUSINESS

HARRY BERNSTEIN / Labor

Sheet Metal Pension Fund Sets Example for Innovation

Even though the nation's pension funds lost a bundle in the market on Oct. 19, Black Monday, nearly $2 trillion is still left in reserves for money managers to handle, and they come up daily with ideas for investing those vast sums.

The primary goal must be to manipulate the money so it will increase and thereby help ensure pensions for retirees. But little attention is paid to what should be an important secondary goal: using the money in ways that will better serve workers who are covered by the pension plans but who are still on their jobs.

However, a few of the nearly 800,000 private and public pension programs are run by people with imaginative suggestions for safe ways to do more for workers than simply increase the huge reserves.

Among the most innovative ideas in the country have been devised for the $1.3-billion Sheet Metal Workers National Pension Fund, which is jointly controlled by union and management trustees.

Most of the ideas came from Edward Carlough, president of the relatively small, 147,000-member Sheet Metal Workers Union. Not a self-effacing man, Carlough nevertheless has reason to be pleased with the success of his proposals so far.

They've done so well, in fact, that, unlike most construction industry unions, the Sheet Metal Workers Union is increasing its membership, which is expected to top its 1978 record of 152,000 by the end of the year.

The membership increase is partly due to cooperative efforts by the union and industry to keep labor costs down in the face of rising non-union competition. But another significant factor is the clever use of some of the pension fund money.

About $75 million has been invested in companies that are bringing a nice return to the pension fund and are creating jobs for sheet metal workers by developing ways to, among other things, increase the use of solar energy and find safe methods to remove life-threatening asbestos from homes, schools and office buildings.

For example, pension reserves have been used to buy about 30% of Chronar Corp., based near Princeton, N.J. Chronar is building what Carlough says will be the world's largest "amorphous silicon photovoltaic" manufacturing plant.

The fund will own the plant that Chronar will manage and also market the photovoltaic cells that turn sunlight into electricity. And sheet metal workers will fabricate and install the product.

"Labor & Investments," a newsletter published by the AFL-CIO industrial union department to keep track of unions' financial investments, says the sheet metal workers' pension fund is the only one making major equity investments in corporations that manufacture products used in jobs held by pension plan participants.

The sheet metal fund also bought 30% of Acmat Corp. based in East Hartford, Conn., a heating, ventilating and air-conditioning company that recently entered the rapidly growing asbestos-removal business, which is providing jobs for sheet metal workers.

But Acmat, like other asbestos-removal firms, is facing increasing trouble buying liability insurance for its asbestos jobs. To help solve that problem, pension funds were used to buy a 30% stake in United Coastal Insurance which offers the mandated asbestos insurance policies.

Another innovative idea was to devise a way to help contractors get performance bonds that small firms often have trouble obtaining. To achieve that goal, the pension fund-financed Acmat last week announced

Please see BERNSTEIN, Page 22

HARRY BERNSTEIN

Continued from Page 1

plans to buy a subsidiary of John Hancock Holding that will offer bonding to qualified asbestos abatement contractors.

Randy Barber, a financial consultant to unions, complains that far too little has been done by unions to make sure that pension fund administrators invest fund reserves not only to protect retirees but also to help active union members.

But he said Carlough and other trustees of the sheet metal pension fund "are doing some exciting, pioneering things that can serve as examples for other unions around the country."

Usually, almost all of the enormous amounts of money in the nation's pension funds are put into "safe" investments such as stocks, bonds and government securities by money managers, who often make small fortunes for themselves in the process.

But relatively small amounts of those vast sums trickle into job-creating construction loans that directly benefit active workers covered by pension plans.

Jobs are opened for construction workers when a construction industry pension fund simply makes a loan to a developer. The developer then hires a building contractor, who hires construction workers. The contractor, in turn, makes pension fund contributions for his workers, thus putting additional money into the fund.

Much more use should be made of money set aside for workers for their retirement to create jobs for them as long as the fund trustees don't violate their fiduciary responsibilities by careless, high-risk, low-return investments.

But much more can be done, as the sheet metal fund trustees are showing, to find other equally intelligent methods for using the huge pension fund reserves for the benefit of workers other than simply investing them in the traditional fashion.

Harbrant Is Honored for Service to Scouts

Unions have fallen on hard times in recent years, and they will not suddenly begin to flourish after May 20, when Robert Harbrant, a dedicated labor leader, is presented with the Silver Buffalo award for "distinguished service to youth" by national officers of the Boy Scouts of America.

But the award does symbolize the first chance unions have ever had in the 78-year history of Scouting in the United States to teach millions of Scouts the positive story of organized labor's role in the economic, social and political life of this country.

And to stop the erosion of their strength, unions need to get their story across to America's youth, the source of their future membership. Sadly, the public schools teach almost nothing about labor unions.

Harbrant, head of the AFL-CIO food and allied services trade department, spearheaded a lengthy campaign to persuade Boy Scout leaders to create a labor merit badge, and the success of the campaign will be marked in ceremonies in San Diego where Harbrant will receive the award. (Other 1988 recipients of the Silver Buffalo include First Lady Nancy Reagan, who received it in January.)

More than 20 years ago, America's business community won the chance to present its most favorable side to Boy Scouts when a business merit badge was created. But when Harbrant and others sought equal treatment for labor, there was strong, often strident opposition.

One draft of the badge requirements designed to help Scouts learn about the American labor movement was completed in 1985. But that was derailed because critics said it didn't ask Scouts to learn about the non-union sector of the work force.

The final battle in what has been tagged "the great badge war" came at a meeting of 19 corporate executives who make up Scouting's special merit badge committee.

The executives indicated that they would approve the labor merit badge only if Scouts were required to learn about allegations of corruption of unions as well as their achievements, according to professor Arthur Shostak, a Drexel University sociologist who has followed the badge war closely.

Harbrant agreed to the idea if, in turn, the corporate executives would add a requirement to the business merit badge spelling out the corporate corruption and white-collar crime "directly linked to the companies of the very businessmen trying to decide the fate of the labor badge," according to Shostak.

That ended the argument: The corruption that exists in both labor and management was not included in the merit badge program.

A 47-page "American Labor" pamphlet has just been issued so that any of this country's 5 million Scouts who want a labor merit badge to help them advance in the ranks of Scouting can get it by learning the story of unionism in the United States.

The Silver Buffalo award to Harbrant is quite appropriate for such an achievement.

CHRONAR

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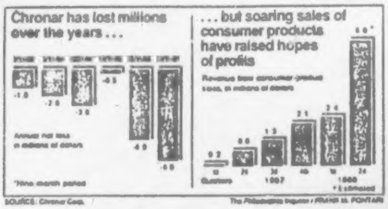
The Philadelphia Inquirer
PHILADELPHIA BUSINESS
A weekly report on business and the economy in the metropolitan area



SOURCE: Chronar Corp.

Chronar draftsman Frank Herdt at work on a project.

Chronar's CEO, Zoltan J. Kiss (left), and president, Jon K. Clemens.

Finally, dawn breaks for N.J. solar firm

By Don Stets
Inquirer Staff Writer

A funny thing has happened at Chronar Corp., a small solar company on a country road outside Princeton. Chronar has started making a profit.

While that would not seem unusual for most businesses, it is something extraordinary for Chronar. The company has had only one other profitable year, 1980, when it earned a penny a share.

The firm has been in business for 12 years and has a balance sheet that would drive most executives to the brink of despair. Not Zoltan J. Kiss, Chronar's Hungarian-born chairman and chief executive officer.

Kiss (pronounced Kish) does not dwell on the past. He has his eyes on the future. What he sees is a trillion-dollar market for his company by the turn of the century. Chronar makes amorphous silicon photovoltaic panels.

"We believe that photovoltaics are the next energy source. We believe that on a global scale, there is no other alternative," said Kiss in an interview last week in his office.

To Kiss, a 56-year-old physicist, the lean years were necessary and inevitable.

Chronar grew from an idea — using amorphous silicon for photovoltaic panels — to the development of products in which the panels could be used. Along the way, the company invented both the manufacturing process and the manufacturing equipment for the panels.

Now the years of struggle are beginning to pay off. Kiss said the company reported an operating profit for the second quarter and expected to report one for the year. Second-quarter earnings were $1.9 million, or 18 cents a share, including extraordinary items. So far, the company has paid dividends only in shares of stock.

Kiss, who founded Chronar in 1976, is one of those entrepreneurs whom analysts describe as having vision. However, the question for a dozen years has been whether that vision could come down to earth long enough to make a profit.

"I think this time they are really are going to do it," said Charles T. Maxwell, senior energy strategist for C.J. Lawrence/Morgan Grenfell in New York City.

Maxwell predicts that Chronar will make operating profits of about 20 cents a share this year, 40 cents a share next year and a dollar a share in 1990.

"I think that they have broken clear," said Maxwell. "It is always a question of heavy costs at first, but when revenues go through those costs, they tend to rocket through. I think that is what we are going to see here."

(See CHRONAR on 7-D)

Solar firm spots light at the end of a long tunnel

CHRONAR. from 1-D

John Westergaard, a managing director for the investment-banking firm of Ladenburg Thalmann & Co. Inc. in New York City, said Chronar was a prospect to watch.

"The fact is that if it can make solar energy on economic terms, this is probably the company with the most open-ended potential over the next several decades. It truly is," he said.

The stock has bounced in a range of $4 to $12 a share for the last 12 months and has been selling most recently for about $8 a share.

The cause of Chronar's recent success is a modest but extremely popular consumer product — a solar-powered outdoor light called the WalkLite. In 1987, the company sold 140,000 of the lights. Already this year it has sold more than 300,000 of them.

Company executives are surprised at the popularity of the light, which sells from about $35 to $60.

No wiring needed

It's advertised as the first-ever solar-powered outdoor light, and it can be installed in gardens and along walkways without the hassle of wiring. It collects sunlight during the day, turns it into electricity that is stored in a battery, and then, at night, the light goes on.

Jon K. Clemens, Chronar's president and chief operating officer, said the the company's revenues from consumer sales had rocketed. They went from only $127,000 for all of 1986 to about $6 million for just this year's second quarter. Revenue from consumer sales will be about $25 million for this year, according to Kiss.

The company has other consumer products, including a solar-powered handlight, a key-chain light and solar-powered chargers that can be used to recharge a car battery when the car is idle.

New products will be introduced soon, including solar-powered house numbers that light up at night and a solar-powered sentinel light that turns on when someone walks in front of an infrared switch.

The company expects to soon begin enjoying some earnings from industrial products, including billboard lighting and solar-powered pumping systems.

But the key to the company's future is solar-powered generating plants that electric utilities could use in the United States to meet peak summer demand and that could be used in remote regions abroad to introduce electricity.

'Wide open'

"Once we demonstrate that we can build a cost-effective, photovoltaic power station, we believe that the photovoltaic industry is wide open and this growth that we talked about is possible," said Kiss.

"The company, in my view, has the best technology for producing solar power," said Russell E. Miller, an analyst with Alex. Brown & Sons in Baltimore.

"In my view, it is getting close to the point where it will be able to compete with other sources of power such as nuclear energy and coal," he said.

Earlier photovoltaics were made out of more expensive silicon crystals. Chronar uses lower-cost amorphous silicon — in a so-called thin-film process in which the silicon is sprayed on glass. The company believes that it has at least a one-year lead over competitors in the United States and Japan in the technology.

Photovoltaic cells convert sunlight directly into energy. When the photons in the sun's rays strike the photovoltaic cells, they activate electrons in the silicon that are harnessed into a current of electricity.

Twenty years ago, solar cells were used only to power satellites in space. The cells were extremely expensive, costing more than $100 for each watt of electricity produced, according to analyst Maxwell.

Just five years ago, the cost was down to about $10 to $12 a watt for fully encapsulated solar panels ready to produce electricity, said Maxwell. But now the cost has come down to about $4 a watt, he said.

At that cost, photovoltaics are beginning to be competitive with the prices paid by utilities to produce electricity for peak demands, particularly to handle summer air-conditioning loads, said Maxwell.

Utilities pay about $2.40 to $3.70 a watt to install power stations. (A large nuclear plant produces about 1,000 megawatts, or 1 billion watts.)

Chronar says its manufacturing cost for the panels has dropped to less than $1 a watt. Next year, the company plans to open a manufacturing plant — the so-called Eureka project — in California, where it expects to lower costs even further.

Also next year, Chronar plans to build a 50-megawatt power station in California. The location and partner for the project have not been announced, but Kiss predicts that the plant will demonstrate the feasibility of a commercial solar-power station.

Chronar already has a small, experimental station in Birmingham, Ala., that is producing about 60 kilowatts of power and has proved to be an "unqualified" success, Kiss said.

Impressive partners

For the new, $22 million manufacturing plant in northern California, Chronar has lined up impressive partners with deep pockets: Pacific Gas & Electric Co., Bechtel Development Co. and the National Pension Fund of the Sheet Metal Workers' International Association.

"This is quite an endorsement for our technology. These guys don't do things lightly. They do a lot of homework," said William M. Beecher, Chronar's vice president.

Chronar employs about 380 people in the United States, including 300 at the headquarters and research center in New Jersey, with the rest at manufacturing operations in Port Jervis, N.Y., and Birmingham.

In addition, the company has embarked on joint partnerships that built plants in South Wales, France and China. Other plants are under construction in Yugoslavia and Hong Kong. Another will begin soon in Taiwan.

Company executives believe that manufacturing abroad will give Chronar penetration into the biggest potential market for photovoltaics: lesser-developed countries.

"There are thousands and thousands of villages on either side of the equator that have no electricity, through South America, Central America, Asia and Africa — something like two billion people or more who are not connected to the grid," said Beecher. "The only way it makes sense for these people to receive electricity is through photovoltaics."

According to Kish, by early in the next century, the world will need to double its current electrical-generating capacity to keep up with demand. That means it will need 2,000 more gigawatts of power — the equivalent of 2,000 nuclear power stations.

If photovoltaics can fill just 10 percent of that need, it would translate into a $1 trillion-a-year industry, he said.